REVENUE INCREASE PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

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REVENUE INCREASE PROPOSALS

WEDNESDAY, JULY 20, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearings follows:]

[Press release of Thursday, June 30, 1983]

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces July Hearings on Revenue Increase Proposals

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold three days of public hearings beginning July 19, 1983, at 10:00 a.m. in the main Committee hearing room, 1100 Longworth House Office Building, to receive testimony on how the Committee should best meet the revenue reconciliation instruction included in the Conference Report on the First Concurrent Resolution on the Budget for fiscal year 1984. This resolution requires the Committee on Ways and Means to report legislation which increases revenues by a total of $73 billion between fiscal year 1984 and fiscal year 1986.

In announcing these hearings, Chairman Rostenkowski stated: "The Committee on Ways and Means has always taken seriously its responsibilities under the Congressional Budget Act. Beginning with the first reconciliation instruction to the Committee in 1980, the Committee has always met its targets in a responsible manner. The seriousness of the long-term economic projections dictates as realistic a response to the fiscal year 1984-86 target as can be achieved. As a result, in these hearings the Committee seeks testimony not only as to approaches to raising the necessary revenues, but testimony as to their timing as well, given the fragile nature of the current economic situtation."

The Committee solicits testimony on specific proposals to increase revenues only, including: (1) the Administration's contingency tax plan included in the President's fiscal year 1984 Budget which would impose a $5-per-barrel excise tax on domestic and imported oil and a surtax on individual and corporate income taxes, which the Administration estimates would raise approximately $137 billion for fiscal year 1985-88; (2) Chairman Rostenkowski's tax freeze proposal which would repeal all tax reductions scheduled to take effect after December 31, 1983, raising approximately the same amount of revenue as the President's contingency tax plan for fiscal year 1985-88; and other proposals which would increase revenues over the period by broadening the tax base, increasing tax rates, improving tax compliance, or other measures.

Further, the Committee solicits the views of witnesses with respect to the preferred timing of revenue increases over the three-year period, fiscal year 1984-1986, given the present and projected state of the economy. Last year, the three-year aggregate revenue increase of $98.3 billion required under the reconciliation instruction contained in the Budget Resolution for fiscal year 1983 was achieved in a somewhat different pattern of annual revenue increases than the specific pattern recommended in the fiscal year 1984 Resolution.

Based on the testimony presented at these hearings, the Committee on Ways and means may deem it appropriate to vary the pattern of specific revenue increases contained in the First Budget Resolution for fiscal year 1984.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than the close of business, Tuesday, July 12, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statement to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance.

Each statement to be presented to the Committee or any written statement submitted for the record must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

(2) A list of any clients or persons, or any organization for whom the witness appears; and

(3) A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, six copies are required and may be submitted by the close of business Friday, July 29, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing begins.

Chairman ROSTENKOWSKI. The committee will come to order.

Good morning, ladies and gentlemen. As we begin hearings on the budget resolution, it might be worth while to note the major differences of the President and the majority in the Congress on this matter.

The President has asked for a revenue increase of $46 million in 1986 by imposing an income surtax and a per barrel fee on oil if the economy warrants. The President opposes any major revenue increases for 1984 and 1983. Congress by contrast has asked for revenue increases totaling $73 billion over the next 3 fiscal years.

The President asked for defense spending increases of 10 percent over inflation. Congress responded with a 5-percent increase, the difference being $26 billion over 3 years.

The President and Congress differ by $10 billion on entitlement cuts and $13 billion on additional nondefense program cuts.

Both the President and Congress agree that deficits will rise more than $550 billion over the next 3 years if we do nothing. There is also considerable agreement that deficits of this magnitude are certain to crowd out private borrowers and ultimately force up interest rates.

Those are the economic facts that confront us. The general consensus in Congress, in the White House and at the Federal Reserve Board is that we cannot sustain annual $200 billion deficits, that revenues must be increased, and that spending must be reduced. However, the political facts tell a different story. Bucking the forces of inertia beginning with the President will take an extraordinary act of political courage from Congress. Cynics are urging

Congress to roll with the President's policy of benign neglect and gamble that the recovery will drift through the election and then we can raise taxes.

Daily reports that the economy is bouncing back after months of recession have clearly lulled many people into believing that $200 billion deficits are manageable, that we can carry them without attempting higher interest rates and inflation.

Then there is the President himself who stands ready to veto any major alternative to his economic agenda.

Those are the political forces lined up against the budget resolution. The questions that I would like addressed in these hearings are the durability of the recovery, whether we have anything to fear from massive deficits, and whether or not Congress should defy conventional political wisdom and attempt to raise taxes and cut spending short of a real economic crisis.

Mr. Conable is recognized.

Mr. CONABLE. Mr. Chairman, thank you.

I find it fascinating that there is absolutely no media interest in this hearing. It may be that the media doesn't take it seriously. I think they should. I think it is a serious effort and one that does require some investigation at this point.

I commend you, Mr. Chairman, for your courage in calling hearings on this most sensitive of subjects. The experience of last summer in enacting the Tax Equity and Fiscal Responsibility Act of 1982, certainly taught us how difficult it is to enact revenue-raising legislation. We are once again faced with the mandate of the budget resolution to increase revenues by $73 billion between fiscal year 1984 and 1986. Many Members of the Congress, members of the public and the financial community believe that no revenue-raising legislation is appropriate at this time so we should proceed with caution in fashioning any legislation intended to raise revenues.

I would like to make several points concerning the subject of these hearings and possible legislation which may be developed as a result of them. First, I do not believe we can ignore the massive deficits which we will be facing in the years to come if no action is taken to control them. There are obviously two approaches, first a reduction in the growth of spending and second, an increase in the level of Federal revenues.

Clearly neither one is a complete answer in and of itself. An article which appeared in the Wall Street Journal, Friday, by Martin Feldstein, Chairman of the President's Council of Economic Advisers described very well the importance of reducing deficits has on long-term prospects for economic growth. Without objection, I would like to include in the record a copy of that article.

[The information follows:]

[From the Wall Street Journal, July 15, 1983]

WHY AND HOW TO CONTAIN RED INK

(By Martin Feldstein)

The economy has shifted into a strong economic recovery. Industrial production, total employment hours, retail sales and other key indicators have all shown rapid growth in recent months. With our greatly reduced inflation rate and substantial unused capacity, the U.S. could be on the verge of a long period of rising real incomes with steady or declining inflation.

Unfortunately, this very favorable outlook is clouded by the prospect of an unprecedented series of federal budget deficits. If there is no legislative action to reduce spending or raise revenue, the deficit is likely to remain at about 5 percent of GNP for the rest of this decade. Deficits would remain at about $200 billion even if the economy were to sustain an above-average rate of real growth for the entire period. Although growth is essential for containing the size of the deficit, even a very robust growth rate cannot solve the deficit problem.

It is important that Congress enact now the changes that will assure substantial declines in the budget deficits of the second half of the 1980s. Failure to do so could have very adverse consequences in both the near and long term.

The primary long-term effect of deficits is to reduce the rate of capital formation. Government borrowing crowds out private borrowing and causes a lower rate of investment. The lower rate of capital formation hurts productivity, decreases growth, limits the rise in real incomes and weakens our international competitiveness.

ECONOMIC DEPRECIATION

To put a budget deficit of 5 percent of GNP into perspective, note that total net savings of the private sector—the savings of households, businesses and pension funds after providing for the economic depreciation of the existing capital stock—has averaged only about 7 percent of GNP for the last quarter century. A budget deficit of 5 percent of GNP would absorb an amount equal to nearly all net saving and would virtually eliminate capital accumulation as a source of productivity growth and rising real incomes.

Over the next three to five years, large budget deficits would alter the balance of the economy and cause a lopsided recovery. The large deficits would keep real interest rates high and reduce activity in all interest-sensitive sectors, preventing them from sharing in the recovery. The machinery and equipment industries, construction, and the producers of steel and other primary inputs used by the these industries would remain abnormally depressed.

No less immportant would be the sharp reduction in our net exports. The anticipation of large deficits raises the real long term interest rate in the U.S. and this causes the dollar to rise relative to other currencies. The high international value of the dollar makes American exports less competitive and makes it easier for foreign producers to sell in the U.S. It is likely that the U.S. merchandise trade deficit—the excess of import over exports—will set a record of more than $60 billion this year, or about 2 percent of GNP. This represents a 50 percent increase from the record 1982 level and is more than double the 1981 level.

The prospect of a lopsided recovery carries the danger that the recovery may lose momentum. Although a recovery with declining unemployment is likely to be sustained even if the prospective deficits remain unchecked, the risk that the recovery will lose momentum is both significant and avoidable. The recovery can be made more secure if legislative decisions are taken now to assure that deficits decline significantly in the years ahead.

The president's budget recognizes the importance of reducing the deficit and proposes legislative action to shrink the deficit to about 2 percent of GNP by 1987–88 as a result of domestic spending cuts and revenue increases. The share of GNP devoted to domestic spending by the federal government has doubled since 1960, to 16 percent. Shrinking that share is essential if we are to avoid perpetual deficits or unacceptable tax increases.

These spending cuts must also be accompanied by additional tax revenue. Ideally, the extra revenue will be forthcoming without a rise in tax rates because economic growth substantially exceeds our forecast. But if this does not occur, the budget calls for an increase in tax rates that begins in October 1985: a 5 percent surcharge on personal and corporate tax payments and a $5-a-barrel tax on imported and domestic oil. The administration remains firmly committed to these standby tax increases.

The extra revenue must be used to reduce prospective deficits, not to finance additional spending. Raising additional revenue only to fund more social spending would continue the process that created our current fiscal morass. That's why the president linked his contingency tax proposal to plans for slowing the growth of government spending. The president has emphasized that he is prepared to use his veto to block outlays in order to achieve this spending control.

Three aspects of the administration's tax proposal should be noted. First, there should be no increase in tax rates in either this year or next while the recovery is getting established. Second, the subsequent conditional tax increase should be enacted this year in order to reassure financial markets and other investors that the deficits will be shrinking. The resulting change in projected deficits would permit an immediate decline in long-term interest rates and a favorable adjustment of the exchange value of the dollar.

The third significant aspect of the president's tax proposal is that it preserves the fundamental tax reforms that were enacted in 1981. Those changes in the tax structure—the reductions in the very distorting top marginal rates, the increased incentives for personal savings and business investment, and the inflation indexing of the tax bracket—are fundamental improvements in the quality of the tax system that needn't and shouldn't be sacrificed to achieve a balanced budget.

Congress mustn't be misled by the small but vocal group of vestigial supply-side extremists who claim that perennial deficits are preferable to tax increases. Although higher tax rates inevitably distort economic incentives, the adverse effects of persistent deficits would be worse. And while the disincentives caused by a rise in tax rates may limit the resulting increase in revenue, no well-designed increase in tax rates could fail to raise total tax receipts.

GRAIN OF TRUTH

Some opponents of the president's proposal for a contingent increase in 1985 tax rates also make the equally implausible assertion that a reduction in the deficit wouldn't permit more capital formation or lower real interest rates because the fall in the government's deficit would be matched by an equal decline in private saving. The grain of truth at the base of this incorrect proposition is that an increase in tax rates will generally cause some decline in private saving. But most types of tax increases, and certainly the tax increases that the administration has proposed for the years beginning in 1985, will cause consumer spending to decline by much more than the decline in saving. Government spending that is financed by deficits is primarily at the expense of private investment while government spending that is financed by general taxes on income or on spending is primarily at the expense of private consumption.

During the next few months, Congress must enact legislation that will assure a sharp decline in future deficits. As the administration's budget shows, this will require a combination of reduced spending and additional revenue. Spending restraint is important not only in itself but because it would be an indication that future revenue increases would be used to reduce the deficit and wouldn't be dissipated in new outlays. Coupled with such spending restraint should be a conditional rise in tax rates that would come into effect only after two years and only if spontaneous revenue growth hasn't been fast enough.

The combination of spending restraint and the enactment now of such tax legislation would provide the much needed evidence that budget deficits will indeed begin declining sharply after the recovery is firmly established. And that evidence now would be the key to a sound and healthy recovery in the months and years ahead.

Mr. **Conable**. I believe the most significant point made by Mr. Feldstein is that the long-term continued success of the economic recovery is dependent on Congress sending some sign to the financial markets that it intends to control deficits in the out years even if that does not involve significant revenue-raising provisions or spending reductions at this time.

We must think long and hard about the merits of Mr. Feldstein's argument in responding to the requirements of the budget resolution to increase revenues by $73 billion between fiscal years 1984 and 1986.

As his second point, I think it is important that as one of the tax writing committees of the Congress we recognize our obligation to continue to monitor and reexamine the operation and structure of the Internal Revenue Code completely irrespective of any revenue-raising considerations. This reexamination requires us from time to time to eliminate obsolete provisions, and modify the functioning of provisions no longer serving the purposes for which they were enacted. This reexamination requires us also to correct inadequate operations of old provisions which may have arisen from new schemes or devises developed by ingenius taxpayers to thwart congressional intent.

We have to protect the revenue base irrespective of whether we raise taxes.

Finally, it requires us to respond to the termination of certain provisions so as not to impose unfair or undue hardships on taxpayers. There are a number of projects which are currently underway which fit into one or more of these classifications. I hope none of these would be delayed because of disagreements relative to the advantages or disadvantages of revenue raising.

I would include among these categories fringe benefits, insurance, the treatment of public property leasing, and H.R. 3475, the Tax Simplification and Improvement Act of 1983, which you and I have sponsored, Mr. Chairman. I hope the committee can continue to progress on these important pieces of legislation whether or not agreement can be reached on general revenue raising.

As a third point, I would like to note any revenue legislation contingent or otherwise should avoid across-the-board rate increases imposed on individual income taxpayers. The greatest accomplishment of the Economic Recovery Act of 1981 was to cease once and for all bracket creep which pushed individual income taxpayers into higher and higher brackets over many years. This was achieved through a 3-year rate reduction and, most importantly, indexation of tax rates scheduled to begin in 1985.

The prolonged and expanding impact of bracket creep is graphically demonstrated by the fact only 3 percent of the individuals faced marginal tax brackets of 30 percent or more in 1960. By 1981, 34 percent of them were at that level.

I do not believe that individual taxpayers should be required to bear the brunt of further across-the-board rate increases of this sort. I look forward to the testimony today and tomorrow on a very difficult and sensitive set of issues. I am hopeful they will be enlightening to all the members of the committee. I do think it is appropriate that we have this hearing and I am grateful to you for having called it.

Chairman ROSTENKOWSKI. The Chair calls Mr. Koplan, Mr. Huard, Dr. Albertine, and Dr. Rahn. Would you all please come to the witness table. Welcome to the committee, gentlemen. We are looking forward to a healthy exchange of views.

Mr. Koplan, if you would identify yourself for the record. You will be the leadoff witness followed by Mr. Huard, Dr. Albertine and Dr. Rahn.

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY ARNOLD CANTOR, ASSISTANT DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH

Mr. KOPLAN. Thank you, Mr. Chairman.

I am accompanied by Arnold Cantor, assistant director of the AFL-CIO department of economic research. I will not read the full text of my statement but will summarize and ask the full text be included in the record.

Chairman **Rostenkowski**. Your entire testimony will be included in the record.

Mr. **Koplan**. Thank you, Mr. Chairman.

The AFL-CIO appreciates this opportunity to present its views on ways to increase Federal revenues. The inability of the Federal tax structure to fund the Federal Government's responsibilities is one of the most critical economic problems confronting the Nation. We believe the key cause of that problem is the administration's so-called "Economic Recovery Tax Act of 1981." Together we can begin to solve that problem by preventing ERTA from doing further damage.

We believe there is much revenue that can be raised through the tax structure in a manner which will help the economy and at the same time add a badly needed element of fairness to national economic policymaking.

We feel the approach Chairman Rostenkowski outlined last February also makes a lot of sense through focusing on the ERTA provisions such as indexing, which are costly, inappropriate, and have as yet not gone into effect.

We recommend a similar approach called for by the AFL-CIO executive council last February which is generally embodied in H.R. 3585, introduced by Representative Thomas Downey. That program, through a combination of measures addressed to the 1981 act and some fundamental reforms, could raise revenues that far exceed the budget resolution targets and lead to a much fairer tax code, and a stronger, balanced, and sustainable economic recovery.

As a result of ERTA, and the revenues it forfeited, this economy faces record-shattering deficits that may well result in the premature end of the current recovery. We are already seeing an upward movement in interest rates, even though recovery is barely underway 11 million workers are jobless and an overvaluation of the dollar, caused by high interest rates, is bringing about further deterioration in trade balances.

In spite of the remedial measures implemented by the Tax Equity and Fiscal Rresponsibility Act in 1982, TEFRA, the huge revenue losses and socially disruptive inequities that were created by the Economic Recovery Tax Act of 1981, ERTA, remain largely in place. It is essential that the Congress continue the effort to recapture lost revenue and restore fairness to the Nation's tax structure.

The administration's contingency tax proposal does at least show a recognition of the need for revenue. However, we see nothing in it that merits support. The contingency tax includes two sources of increased revenues. The first would be a 5-percent surcharge on individual and corporate tax liabilities, and the second would be a $5 per barrel excise tax on domestic oil. These would be triggered if—in projections made in 1985—the deficit share of fiscal year 1986 GNP exceeds 2.5 percent.

A second prerequisite is that the national economy must be growing. And, finally Congress must have agreed to the administration's proposed spending reductions.

We believe a surtax on the present inequitable tax base would compound unfairness as would an excise tax on oil. Moreover, the conditions attached to the administration's measure would probably heighten uncertainty, fears of inflation, and pressures to raise interest rates.

We are concerned that in the search for revenue, base-broadening would become a facade for measures such as the administration's proposal to tax employer contributions to employee health insurance programs.

We are pleased that the chairman's freeze proposal also called for rejecting current consideration of proposals such as enterprise zones and tuition tax credits.

A key element of both the chairman's freeze proposal and the Downey bill, H.R. 3585, is repeal of the indexation provisions of the Economic Recovery Tax Act of 1981. In 1985, and thereafter, the Federal Government will still be faced with huge deficits and if repealed, indexing will increase revenues by $6.2 billion in fiscal year 1985 and $16.7 billion in fiscal year 1986. The AFL-CIO strongly supports the repeal of indexing.

Without indexing, the system of progressive tax rates automatically serves as a contracyclical force, moderating excessive demand during inflationary periods and helping to sustain purchasing power during recessions. If indexing goes into effect, however, the tax structure will automatically adjust in a procyclical fashion, adding momentum to inflations and recessions.

Moreover, the ability of Government to use discretion in the conduct of tax policy would be severely curtailed by the linking of tax rates to the rate of inflation and by default, monetary policy would become an even more dominant factor in the economy.

As part of both the Downey bill, H.R. 3585, and the AFL-CIO comprehensive program for economic recovery and industrial renewal, there are targeted a number of the wider loopholes that violate fairness and are especially costly and harmful to the U.S. economy. By repealing indexing and cutting back the loopholes, the tax features of the AFL-CIO's economic program would raise more than $120 billion in fiscal years 1984-86—approximately $50 billion more than called for in the budget resolution. The $700 cap would have added over $21 billion in revenues during this 3-year period.

The AFL-CIO supports scaling down so-called savings incentives. We particularly urge repeal of the exclusion from taxation of 15 percent of interest income above mortgage interest payments, up to $6,000 on a joint return and $3,000 on a single return. This should be repealed before it goes into effect in 1985. This would save some $4 billion in 1984-86.

We note that this is also in the chairman's proposals.

Another tax loophole mistakenly characterized as a savings incentive is the exemption from taxation of individual retirement accounts. The higher a taxpayer's income, the greater is the tax windfall this gimmick provides. To make the IRA somewhat more equitable, the tax benefit should be changed from an exclusion from gross income to a credit which would provide the same dollar benefit amount regardless of the taxpayer's bracket.

Most of the funds attracted by these tax gimmicks are not new or additional savings, but are merely shifts reallocated from other assets. Further, these gimmicks, along with the increased deficit, add to the competition for funds and push up interest rates.

Another feature of the Tax Code high on our list is the 60-percent exclusion from income of capital gains.

The AFL-CIO supports restoring the capital gains exclusion to the 50-percent level that prevailed before 1979, and beginning in 1985, the exclusion should be phased out over a 5-year period, with adequate protection for homeowners. This would raise $2.6 billion in fiscal year 1985 and $5.4 billion in fiscal year 1986.

The Federal tax system was skewed further in favor of the wealthy by the virtual elimination of the estate and gift tax in 1981 by ERTA. By 1987, when the rate cuts and increases in exemptions enacted in 1981 will be fully phased in, only 0.3 percent of all estates will be subject to estate taxes, and the liabilities of these few estates that are taxed will be substantially reduced.

Restoration of the estate and gift tax to its former structure, which allowed $250,000, or over half of the estate, whichever is greater, to be passed on to the surviving spouse tax free and provided generous credits for heirs would raise $3.7 billion in fiscal year 1985, and $5.0 billion in fiscal year 1986.

As a result of the business provisions of the Economic Recovery Tax Act of 1981, the corporate income tax has been virtually eliminated. We call for reinstatement of the corporate income tax as a source of revenue, equity, and economic balance. Primarily because of the accelerated cost recovery, ACRS, provisions in the 1981 Act, corporate tax revenues for the 1983 and 1984 budgets are estimated at only $35.3 and $51.8 billion, respectively.

The massive volume of revenues given away by ACRS has failed to generate the huge increase in corporate capital investment and general economic growth and prosperity that was the basis of its enactment.

We also support the restoration of a portion of lost corporate tax receipts by ending the tax subsidies that encourage the overseas operations of U.S.-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, and spurred the outflow of U.S. capital, technology, and know-how.

Specifically:

FOREIGN TAX CREDIT

The present practice of allowing dollar-for-dollar credits against a multinational company's U.S. income tax liability is a loophole which encourages U.S. corporations to produce abroad. Foreign taxes should be deducted just like other costs of doing business.

DEFERRAL

The deferral privilege allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home—which may never occur.

DISC

Elimination of the Domestic International Sales Corporation, DISC, which allows corporations to spin off income and profits into export subsidiaries in order to defer, perhaps indefinitely, taxes on export profits.

Ending these three foreign tax subsidies would raise $6.5 billion in revenues in fiscal year 1984 and over $33 billion in the 1984-86 period.

THE INVESTMENT TAX CREDIT

In 1982 Congress went halfway toward eliminating the practice of deducting, as depreciation allowances, costs that were already deducted as investment credits. If the job was completed and business was required to reduce the depreciation base by the full ITC rather than only one-half over $4 billion would be recaptured in the 3-year 1984-86 period. Cutting the credit back from 10 percent to its previous 7-percent level would raise over $14 billion in the 1984-86 period.

The "small business" rate. Under present law, the first $100,000 of corporate net profit is taxed at a minimum of 26.75 percent. This low rate, justified as a device to cut taxes on small business, also applies to large corporations. Moreover, the largest corporations receive the lion's share of the tax break. Limiting this lower rate to smaller corporations—phased out between $100,000 and $200,000—would raise over $4 billion in the 3-year 1984-85 period. It should also help the competitive position of smaller businesses.

OIL AND GAS

High on the list of unfinished business is the elimination of the special tax loopholes for the oil and gas industry. Eliminating percentage depletion and the immediate expensing of drilling costs and terminating ERTA's windfall profit tax changes would increase revenue in 1984 by $3.7 billion and generate a cumulative revenue increase of over $15 billion during the 1984-86 period.

We also believe that a temporary surtax should be enacted to meet the current defense budget needs. Such a tax should be levied on both corporations and individuals; the rate should be graduated, and it should include as part of its base the income that currently escapes tax through phantom writeoffs, special exclusions, and shelters.

In conclusion, the AFL-CIO's proposed loophole closing program, H.R. 3585, and the chairman's proposals all, in our view, point up the fact that budget targets as well as broader economic goals of the Federal Government to promote job creating, balanced growth can be accomplished through enhancing, not sacrificing equity.

Thank you, Mr. Chairman.

[The statement of Mr. Koplan follows:]

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. Chairman, the AFL-CIO appreciates this opportunity to present its views on ways to increase federal revenues.

The inability of the federal tax structure to fund the federal government's responsibilities is one of the most critical economic problems confronting the nation. We believe the key cause of that problem was the Administration's so-called Economic Recovery Tax Act of 1981 (ERTA).

The 1981 Act is bringing huge benefits to corporations and the super rich, at the expense of school children, the elderly, the unemployed and the disabled and the disadvantaged. Those who are paying for those giveaways are the victims of massive cuts or elimination of health services, aid to schools, food stamps, aid to states and cities and a long list of other social programs to help people who have no place to turn. It was loaded with unfair and costly gimmicks that widened the gap between the nation's haves and have-nots while imposing a huge, continuing and destablilizing drain on our resources.

Together, we can begin to solve that problem by preventing ERTA from doing further damage. We believe there is much revenue that can be raised through the tax structure in a manner which will help the economy and at the same time add a badly needed element of fairness to national policymaking.

As this committee knows, the AFL-CIO strongly supported H.R. 1183, the Tax Rate Equity Act of 1983, to place a $700 cap on the third year of ERTA as an important step towards equitably preventing the loss of a significant portion of the revenues that is now being foregone as a result of the failure to pass that legislation. We appreciate the support this Committee and the Congress gave H.R. 1183 despite the all-out and ultimately successful opposition of the Administration.

Similarly, we feel the approach Chairman Rostenkowski outlined last February also makes a lot of sense through focusing on the ERTA provisions such as indexing, which are costly, inappropriate, and have as yet not gone into effect.

We are here basically to recommend a similar approach called for by the AFL-CIO Executive Council last February which is generally embodied in H.R. 3585, introduced by Representative Thomas Downey. That program, through a combination of measures addressed to the 1981 Act and some fundamental reforms, could raise revenues that far exceed the budget resolution targets and lead to a much fairer tax code, and a stronger, balanced and sustainable economic recovery.

As a result of ERTA, and the revenues it forfeited, this economy faces record-shattering deficits that may well result in the premature end of the current "recovery." We are already seeing an upward movement in interest rates, even though "recovery" is barely underway eleven million workers are jobless and an over-valuation of the dollar, caused by high interest rates, is bringing about further deterioration in trade balances.

In spite of the remedial measures implemented by the Tax Equity and Fiscal Responsibility Act in 1982 (TEFRA), the huge revenue losses and socially disruptive inequities that were created by the Economic Recovery Tax Act of 1981 (ERTA), remain largely in place. It is essential that the Congress continue the effort to recapture lost revenue and restore fairness to the nation's tax structure.

Fully one-half of the 1984 deficit—or $92 billion—is attributable to the ERTA. And, even after the adjustments that were made by TEFRA, a $520 billion cumulative deficit has been projected for the 3-year period from 1984-1986—two-thirds of this deficit is attributable to ERTA.

The Administration's "contingency" tax proposal does at least show a recognition of the need for revenue. However, we see nothing in it that merits support. The contingency tax includes two sources of increased revenues. The first would be a 5 percent surcharge on individual and corporate tax liabiliities, and the second would be a $5 per barrel excise tax on domestic oil. These would be triggered if—in projections made in 1985—the deficit share of fiscal year 1986 GNP exceeds two and one-half percent. A second prerequisite is that the national economy must be growing. And, finally Congress must have agreed to the Administration's proposed spending reductions. We believe a surtax on the present inequitable tax base would compound unfairness as would an excise tax on oil. Moreover, the conditions attached to the Administration's measure would probably heighten uncertainty, fears of inflation, and pressures to raise interest rates.

A more realistic—and more immediate—approach to revenue raising and tax reform is urgently needed. Last year, the Congress took the first step in this direction.

Before highlighting H.R. 3585, which basically includes the AFL-CIO's revenue raising program, we would like to say a few words about some of the more far-reaching tax proposals which have been receiving a good deal of attention—particularly the efforts to change the income tax to a consumption or expenditure tax and the so-called "flat tax" notions. As a general observation, these proposals don't follow the principle that we believe must provide the basis for a fair tax structure: ability to pay. Instead, these proposals have been justified because they supposedly would promote economic efficiency. We would disagree, however, with the nation that economic efficiency requires that the tax structure be unfair.

An examination of the results of the Economic Recovery Tax Act of 1981 should immediately dispel the notion that unfairness is a prerequisite to growth. As a result of the 1981 law and the depressing influence of tight money, this country experienced the worst downturn in fifty years. Only, after nearly two years of job destruction, is the economy showing signs of strength. Yet business investment—which was supposed to achieve particularly strong growth because of the 1981 tax law's Accelerated Cost Recovery (ACRS) provisions, has continued its downward slide this year. And, the gaps between the Administration's haves and have nots have widened substantially.

The flat tax has frequently been combined with or confused with proposals to broaden the tax base by paring down deductions, exemptions, and exclusions. Base-broadening measures can—and should—be accomplished without sacrificing the progressivity of the tax structure. We are also concerned that in the search for revenue, "base-broadening" would become a facade for measures such as the Administration's proposal to tax employer contributions to employee health insurance programs.

We are pleased that the Chairman's "Freeze" proposal also called for rejecting current consideration of proposals such as enterprise zones and tuition tax credits.

A key element of both the Chairman's "Freeze" proposal and the Downey bill, H.R. 3585, is repeal of the indexation provisions of the Economic Recovery Tax Act of 1981. In 1985, and thereafter, the federal government will still be faced with huge deficits and if repealed, indexing will increase revenues by $6.2 billion in fiscal year 1985 and $16.7 billion in fiscal year 1986. The AFL-CIO strongly supports the repeal of indexing.

Without indexing, the system of progressive tax rates automatically serves as a contracyclical force, moderating excessive demand during inflationary periods and helping to sustain purchasing power during recessions. If indexing goes into effect, however, the tax structure will automatically adjust in a procyclical fashion, adding momentum to inflations and recessions. Moreover, the ability of government to use discretion in the conduct of tax policy would be severely curtailed by the linking of tax rates to the rate of inflation and by default, monetary policy would become an even more dominant factor in the economy.

Despite claims that non-indexed taxes have given Congress unauthorized freedom to spend during periods of inflation, the record shows that the federal government has not launched new expenditure programs. Rather, the government has used the revenue increases resulting from inflation to reduce taxes. This is a result of the government's ability to use its discretion in setting tax rates to respond to economic conditions and social considerations.

For the last several decades despite the general upward trend in prices, the effective tax rate on individual income has not risen and any fluctuations have been within a rather narrow band.

As part of both the Downey bill, H.R. 3585, and the AFL-CIO comprehensive program for economic recovery and industrial renewal, there are targeted a number of the wider loopholes that violates fairness and are especially costly and harmful to the U.S. economy. By repealing indexing and cutting back the loopholes, the tax features of the AFL-CIO's economic program would raise more than $120 billion in fiscal years 1984-1986—approximately $50 billion more than called for in the Budget Resolution. The $700 cap would have added over $21 billion in revenues during this 3-year period.

The AFL-CIO supports scaling down so-called savings incentives. We particularly urge repeal of the exclusion from taxation of 15 percent of interest income above mortgage interest payments, up to $6,000 on joint return and $3,000 on a single return. This should be repealed before it goes into effect in 1985. This would save some $4 billion in 1984-1986.

Another tax loophole mistakenly characterized as a savings incentive is the exemption from taxation of individual retirement accounts. The higher a taxpayer's income, the greater is the tax windfall this gimmick provides. To make the IRA somewhat more equitable, the tax benefit should be changed from an exclusion from gross income to a credit which would provide the same dollar benefit amount regardless of the taxpayer's bracket.

These "savings" devices cost billions of dollars in lost revenue, and despite their title and intent, result in direct and immediate reduction in national savings. For savings to actually increase, private savings must increase more than this reduction in the Treasury's revenues. Most of the funds attracted by these tax gimmicks are not new or additional savings, but are merely shifts reallocated from other assets. Further, these gimmicks, along with the increased deficit, add to the competition for funds and push up interest rates.

Another feature of the tax code high on our list is the 60 percent exclusion from income of capital gains. Combined with the lowering of the maximum tax rate to 50 percent by ERTA, this exclusion reduces the maximum tax rate on capital gains only to 20 percent. This exclusion costs the Treasury $18 billion a year in revenues and primarily benefits the wealthy—with the top 5 percent of taxpayers getting 60 percent of the benefits.

The AFL-CIO supports restoring the capital gains exclusion to the 50 percent level that prevailed before 1979, and beginning in 1985, the exclusion should be phased out over a 5-year period, with adequate protection for homeowners. This would raise $2.6 billion in fiscal year 1985 and $5.4 billion fiscal year 1986.

The federal tax system was skewed further in favor of the wealthy by the virtual elimination of the Estate and Gift Tax in 1981 by ERTA. By 1987, when the rate cuts and increases in exemptions enacted in 1981 will be fully phased in, only 0.3 percent of all estates will be subject to estate taxes, and the liabilities of these few estates that are taxed will be substantially reduced.

There has been an increasing move towards the exemptions of capital from taxation—exemplified by such ineffective savings incentives as IRA's, All-Savers Certificates, and interest and dividend exclusions, as well as the virtual elimination of tax on corporate capital. The reduction of estate and gift taxes eliminates an important and equitable constraint on the accumulations and intergenerational transfers of vast fortunes. Equity considerations require effective taxation of accumulated wealth and the recent array of exemptions of capital from taxation makes this even more urgent.

Restoration of the estate and gift tax to its former structure, which allowed $250,000, or over half of the estate (whichever is greater) to be passed on to the surviving spouse tax free and provided generous credits for heirs would raise $3.7 billion in fiscal year 1985, and $5.0 billion in fiscal year 1986.

As a result of the business provisions of the Economic Recovery Tax Act of 1981, the corporate income tax has been virtually eliminated. We call for reinstatement of the corporate income tax as a source of revenue. equity, and economic balance. Primarily because of the accelerated cost recovery (ACRS) provisions of the 1981 act, corporate tax revenues for the 1983 and 1984 budgets are estimated at only $35.3 and $51.8 billion, respectively. At these levels, corporate receipts will be only 5.9 percent of total 1983 budget receipts and 7.8 percent of anticipated 1984 revenue. In 1980, the ratio was 12.5 percent, and in 1970, it was 17 percent. In 1960—before the enactment of depreciation speedups, the investment tax credits, and rate reductions—the corporate income tax financed nearly 25 percent of the entire federal budget. If the corporate income tax were to bear the same share of the federal tax burden in 1984 as it did in 1980, receipts would be $30 billion higher.

This massive volume of revenues given away by ACRS has failed to generate the huge increase in corporate capital investment and general economic growth and prosperity that was the basis of its enactment. Instead, after the passage of the 1981 Tax Act, the economy plunged into the worst downturn since the Great Depression. The drop in business investment was even worse than the overall economic decline. Furthermore, surveys of business anticipations as well as public and private forecasts indicate that the decline in business investment (constant $) will persist this year. Among the reasons for this abject failure was that ACRS increased the federal deficit and, in combination with monetary policy, drove up interest rates. This interest rate increase dwarfed any direct reduction in the cost of capital generated by ACRS. While there was a great deal of publicity about the need to increase investment, business investment as a proportion of GNP was actually higher in the late 1970's than it was during the 1960's, when productivity grew at a faster rate.

Historically, business investment has closely followed the overall strength of the economy and has not been strongly affected by tax changes. Because companies receive tax benefits even if they don't increase investment, the tax savings can be used to pay dividends, increase executive compensation, invest overseas, speculate, or be used for corporate takeovers.

Moreover, ACRS—which was justified largely as a means to correct depreciation allowances for inflations affect on replacement costs, radically shortened the write-off periods. However, any correlation between these tax "cost" recovery periods and inflation or useful life is purely accidental. Also by favoring more heavily capitalized firms and industries, the ACRS provisions have made it more difficult for small firms to compete, more advantageous to use "capital" instead of labor and has severely distorted investment decisions. In sum, the ACRS provisions violate the principles of equity and efficiency and have significantly contributed to the federal deficit problem. We also support the restoration of a portion of lost corporate tax receipts by ending the tax subsidies that encourage the overeseas operations of U.S.-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, and spurred the outflow of U.S. capital, technology, and know-how.

Specifically:

FOREIGN TAX CREDIT

The present practice of allowing dollar-for-dollar credits against a multinational company's U.S. income tax liability is a loophole which encourages U.S. corporations to produce abroad. Foreign taxes should be deducted just like other costs of doing business.

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The deferral privilege allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home—which may never occur.

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Elimination of the Domestic International Sales Corporation (DISC) which allows corporations to spin off income and profits into export subsidiaries in order to defer, perhaps indefinitely, taxes on export profits.

Ending these three foreign tax subsidies would raise $6.5 billion in revenues in fiscal year 1984 and over $33 billion in the 1984-1986 period.

THE INVESTMENT TAX CREDIT

In 1982 Congress went halfway toward eliminating the practice of deducting, as depreciation allowances, costs that were already deducted as investment credits. If the job was completed and business was required to reduce the depreciation base by the full ITC rather than only one-half, over $4 billion would be recaptured in the 3-year 1984-1986 period. Cutting the credit back from 10 percent to its previous 7 percent level would raise over $14 billion in the 1984-1986 period.

THE "SMALL BUSINESS" RATE

Under present law, the first $100,000 of corporate net profit is taxed at a minimum of 26.75 percent. This low rate, justified as a device to cut taxes on small business, also applies to large corporations. Moreover, the largest corporations receive the lion's share of the tax break. Limiting this lower rate to smaller corporations (phased out between $100,000 and $200,000) would raise over $4 billion in the 3-year 1984-1986 period. It should also help the competitive position of smaller businesses.

OIL AND GAS

High on the list of unfinished business is the elimination of the special tax loopholes for the oil and gas industry. Eliminating percentage depletion and the immediate expensing of drilling costs and terminating ERTA's Windfall Profit Tax changes would increase revenue in 1984 by $3.7 billion and generate a cumulative revenue increase of over $15 billion during the 1984-1986 period.

We also believe that a temporary surtax should be enacted to meet the current defense budget needs. Such a tax should be levied on both corporations and individuals; the rate should be graduated, and it should include as part of its base the income that currently escapes tax through phantom write-offs, special exclusions and shelters.

In conclusion, the AFL-CIO's proposed loophole closing program, H.R. 3585, and the Chairman's proposals all in our view point up the fact that budget targets as well as broader economic goals of the federal government to promote job creating, balanced growth can be accomplished through enhancing not sacrificing equity.

Chairman ROSTENKOWSKI. Thank you, Mr. Koplan.

Mr. Huard, you may proceed.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT OF TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Huard**. Thank you, Mr. Chairman.

I am Paul Huard, vice president of taxation and fiscal policy, National Association of Manufacturers.

I am pleased to be here and present the association views this morning. I would like to summarize those views and request my full statement be inserted in the record.

Chairman **Rostenkowski**. Without objection, that will be done.

Mr. **Huard**. We do not believe that the Congress should raise taxes at all over the near term. By this we mean fiscal years 1984 and 1985. In our view enactment of increased taxes during such period would weaken the economy and indeed prematurely abort the current economic recovery.

I should note that with respect to fiscal year 1984 and 1985 our position is similar to what I understand to be the position of the administration. However, we have not adopted this position because it is the administration's position. Rather, we held this position overtly and consistently since the enactment of TEFRA in 1982.

As to taxes for fiscal years 1986 and beyond, we can see the possibility that tax increases at that time may prove necessary. However, enacting tax increases today to take effect 3, 4, 5 years from now requires Congress to guess what the state of the economy will be in such future time. While such a guess would be made in all good faith the historical record indicates a poor likelihood that it will be right.

We think it is far better to wait at least a year or two and see what effect the recovery has on Federal receipts and expenditures. At a later point, say spring 1985 Congress would be in a better position to assess the amount and nature of any tax increases that may be required for fiscal years 1986 and beyond.

I have a few specific comments on the various pending proposals that have been made. As to the administration's contingency tax, we tend to regard the mere fact that it is contingent as an objectionable feature. Frankly if there is one thing that we can use in the investment and business planning process it is a little certainty. We thought briefly we had that after the enactment of ERTA in 1981 but last year's bill TEFRA certainly proved us wrong and we don't think it is particularly appropriate to add additional uncertainties to the capital and business planning process by providing a contingent tax.

As to specific taxes contained in the administration's contingency program, we don't feel that either of them represents particularly good tax policy. As to the oil tax, certainly it would impact unfairly and unevenly as to geographic and industry sectors both.

With respect to the surtax, such a tax is inherently unfair and the highest surtaxes will be paid by the companies and individuals already paying the highest effective rates.

With respect to the tax-freeze proposal made by the chairman of this committee which would raise roughly a comparable amount of revenue to the administration's contingency tax proposals over

1985 through 1988, we would probably have to oppose the tax freeze on the ground that it would repeal the indexes of individual tax rates scheduled to take effect in 1985. Our view might be different if it were a deferral, but certainly we oppose any outright repeal of indexing.

In point of fact, I think we would oppose any modification of the indexing of individual tax rates that is not accompanied by a similar adjustment or modification to index entitlement programs. For instance, if the Congress were willing to index entitlement programs to 60 percent of the CPA, it would be a fine idea to do the same with the indexing of individual tax rates. But to do it on one side of the equation and not the other is to just throw away a tremendous opportunity to ultimately do something about the runaway entitlement spending that this Government has been engaging in.

I realize that our recommendations with respect to not increasing taxes, if followed, will not leave the tax-writing committees of Congress a great deal to do over the next several years. However, I would suggest one important inquiry which could be undertaken in both this committee and the Senate Finance Committee, to really start taking a serious look at alternative methods of taxation.

I think there are many people who would concede that the Internal Revenue Code of 1954, which has been on the books for five decades and is encrusted with more and more layers of exceptions to exceptions and complications to complications, is reaching the point where it is in serious danger of collapsing of its own weight.

I think that alternative methods of taxation would shift the burden of taxation away from savings and investment, away from the anticapital formation bias inherent in the current code, and move toward taxing consumption, would represent a fruitful area of inquiry for this committee and the Senate Finance Committee.

I am not suggesting any particular consumption tax at this time. We are studying this matter ourselves to determine what we think might be a viable recommendation. But I think it is an inquiry well worth making.

Thank you very much.

[The statement of Mr. Huard follows:]

STATEMENT OF PAUL R. HUARD, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

I am Paul R. Huard, Vice President of Taxation and Fiscal Policy for the National Association of Manufacturers. On behalf of NAM's 13,000 members who represent 80 percent of the nation's industrial output and 85 percent of its industrial workforce, I am pleased to have this opportunity to present our views on the subject of revenue increases.

SUMMARY

The issue of tax law changes to increase revenues has arisen primarily because of the magnitude of the federal deficits projected for the next several years. Specific proposals include: (1) the Administration's plan for contingency tax increases included in its fiscal year 1984 budget proposal but which would not take effect until fiscal year 1986; and (2) the "tax freeze" proposal made by Chairman Rostenkowski of this committee, which would rescind any tax reductions scheduled to take effect after the end of this year. Both proposals have roughly the same aggregate revenue impact over the near to intermediate term, although there are differences in both the timing and the distribution of the tax increases thereunder.

This statement argues against raising taxes at the present time. Current economic circumstances are such that any immediate tax increases would jeopardize the recovery and lead to a weaker economy. Moreover, although the outyear deficits represent a serious problem, whatever tax measures are necessary to deal with them should be enacted later rather than at the present time. Enactment of a tax increase for the outyears now would prove to be good policy only if economic circumstances turned out to be favorable at that time. However, in view of the uncertainty attached to the long-term economic outlook, there is no guarantee that any tax increases legislated now would constitute an appropriate policy in the outyears. Under the circumstances, it would be preferable to wait until a future date before deciding as to whether such tax increases would be justified.

Finally, to the degree that it may become necessary to raise taxes at some future date, Congress should seriously consider structural changes which would correct the present anti-capital formation bias of the nation's tax laws, for instance by shifting the burden of taxation away from savings and investment and towards consumption.

I. THE GENERAL CASE AGAINST TAX INCREASES

1. The most important short-term consideration to be applied in any decision regarding tax policy has to do with the sustainability of the current economic recovery. At the present time, the recovery has lasted only two quarters, of which the first was unusually weak. This recovery comes in the wake of a prolonged recessionary period in which the economy underwent two downturns in three years, during which capacity utilization and unemployment reached their postwar low and high points respectively. Furthermore, although the second quarter was quite strong, there remains considerable doubt as to how long the recovery can be sustained. In our view, the recovery may well be shorter than the average postwar upturn in which expansion continues for over four years. Under these circumstances, raising taxes at the present time or in the near future would seriously undermine the prospects for continued recovery. The proximate effects of a tax increase would be a contraction in aggregate demand, followed by a curtailment of production. Real growth would slow down and the recovery would proceed at a much less rapid pace than in the second quarter. The reduced momentum of expansion would in turn militate against the recovery becoming self-sustaining.

2. One of the results of the prolonged recessionary period has been a serious deterioration in business profitability and liquidity. Several indicators confirm the magnitude of the problem. During the 1981–82 recession, after-tax profits in constant dollars declined −22 percent, while since 1979 real profits have contracted by approximately −30 percent. Furthermore, profits had previously been depressed for a long time during the 1970s, as a result of factors such as price controls, excessive taxation and decreasing real rates of return on investment, all of which translated into a significant narrowing of profit margins. Side-by-side with the decline in profitability, there has been a corresponding decline in corporate liquidity. The debt-equity ratio, an important measure of the long-term solvency of corporations, is now about three times its level of the mid-1960s. As a result of the aggravated corporate reliance on debt in a high interest rate environment, an increased share of business cash flow has been diverted into debt service. At the trough of the 1981–82 recession, roughly half of all corporate pretax income was devoted to payments on debt.

Given that corporate liquidity is at its lowest level of the postwar era and real profits are at their lowest level in twenty years, any increase in business taxation, which would further reduce corporate cash flow, would have serious consequences for economic growth, employment and capital investment.

3. Although it has periodically been alleged that the tax cuts enacted under the Economic Recovery Tax Act of 1981 (ERTA) were a failure, their actual effect appears to have been to mitigate the decline in economic activity during the recent recession, and they are projected to add positively to economic growth during the recovery. This conclusion is supported in a recent study by Data Resources, Inc. In econometric simulations which set up hypothetical scenarios for the economy with the pre-ERTA tax laws still in effect, DRI found that the recession of 1981–82 would have been considerably deeper—while the subsequent recovery would have been less robust—in the absence of the ERTA tax reductions. The conclusion is that the ERTA tax cuts offset the worst effects of the recession, and are now contributing to a faster expansion of economic activity.

4. In addition to these specific arguments against raising taxes at the present time, a series of arguments can be made against raising business taxes in general. Paramount among these is the fact that business has received a disproportionately

small share of the benefits of the ERTA tax cuts, while bearing an even more disproportionate share of the subsequent tax increases enacted under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

In 1981 the business provisions of ERTA—primarily the Accelerated Cost Recovery System (ACRS)—were passed in order to stimulate greater investment in plant and equipment. ACRS went quite far in redressing the problem of excessive taxation of the capital sector by providing much more realistic depreciation allowances than the previous Asset Depreciation Range (ADR) system, which had become increasingly obsolete during the 1970s.

Nevertheless, the ERTA business tax cuts were attacked as "too generous" by critics who alleged that ACRS together with the investment tax credit would result in negative tax rates on corporate income. On closer examination, however, it can be seen that this claim was founded in unrealistic assumptions about the rate at which depreciation deductions are discounted for inflation. With a more realistic measure of the inflation discount, ACRS does not yield negative rates of taxation. Furthermore, despite the allegations of excess, by historical standards the ERTA tax cuts were not disproportionately oriented toward business. Only 20 percent of the total ERTA tax cuts were allocated to business. Typically, business has received a greater share of major tax reductions: over 25 percent under the Tax Reform Act of 1976, and nearly 35 percent under the tax cuts of 1962-65.

Not only did the business sector receive a comparatively low share of the ERTA tax cuts, it was subject to a disproportionately high percentage of the 1982-TEFRA tax increases. TEFRA in effect took back from business well over half of the dollar value of the ERTA business tax cuts enacted in 1981. For some companies, particularly high-technology firms with relatively short-lived assets, the 1982 tax increase left them with less in depreciation allowances than they had under the old rules. All told, the business tax increase enacted in 1982 accounts for about half of the revenue to be raised under TEFRA over fiscal year 1983-fiscal year 1985. The imbalance is obvious: business received only 20 percent of the tax cuts enacted in 1981 but must bear 50 percent of the tax increases enacted in 1982. Additional tax increases on business could effectively negate all the ERTA capital formation incentives and could well leave some businesses worse off than before the enactment of ERTA.

5. During past decades, corporate income has been subject to excessive taxation. From the late 1960s onward, the real (i.e., inflation-adjusted) rate of corporation taxation has tended to be higher than the statutory rate. This occurred primarily because the ADR system was inadequate for recovery of capital expenditures in an inflationary environment. Under ADR, depreciation could only be calculated on the basis of the original purchase price of the equipment, rather than on the basis of the current cost of replacement, and could only be written off over the equipment's "useful life," typically a fairly long period. Therefore, in an environment where the replacement cost of capital equipment greatly exceeded its acquisition cost, ADR seriously understated depreciation costs. When the effects of understatement of depreciation are added to the tendency of conventional accounting procedures to overstate inventory profits during inflationary periods, the result is that effective corporate tax rates averaged over three percentage points higher than statutory rates during the 1970s. During the period from 1970 to 1978, real corporate tax rates were over 51 percent, compared with the statutory rate of 48 percent in effect at that time.

Furthermore, other industrial countries have generally provided better capital investment incentives than the United States. With ADR in effect, American tax law provided lower depreciation benefits than in Canada, Western Europe and Japan. The difference in the tax treatment of investment is one reason why the share of GNP comprised by business fixed investment has historically been lower in the United States than in most other industrial countries. The enactment of ACRS provided American industry with depreciation allowances comparable to those historically available to our competitors and would have enabled American companies to compete more effectively in world markets. Unfortunately, ACRS has already been diluted by TEFRA, and any further changes would tend to return us to the pre-1982 situation of providing a markedly inferior system of depreciation allowances.

6. The historical experience with business tax cuts corroborates the view that the ERTA reductions should be left in place. Previous tax cuts to encourage capital formation have been associated with increases in profitability, investment and real economic activity, while tax increases on the capital sector have generally been associated with slower growth, contractions in profits and declining investment.

In 1962-65 period, a series of tax cuts were passed. The main business provisions being the investment tax credit (ITC), accelerated depreciation, and a four point corporate rate cut. The economy underwent considerable expansion at this time. In

1962-66, real profits increased 48 percent. Real business fixed investment grew at an annual average of 7.5 percent. Real GNP growth averaged 5.3 percent annually over the five period, with growth rates attaining 6 percent per year in 1965-66.

In late 1968, taxes were raised in the wake of the Vietnam War deficits. The ITC was repealed, and an 18-month surcharge was imposed on corporate and individual income. In the recession of 1969-70, real profits declined 22 percent; real businesss fixed investment declined 3.4 percent and economic activity also fell. The expiration of the surcharge, on the other hand, combined with other tax cuts in 1971, contributed to a sharp recovery during the early 1970s. In the recovery of 1971-73, real profits rose 39 percent over their level of 1970; real investment grew by 9 percent annually, and real GNP grew by 5 percent per year.

The tax cuts of 1975-76 were also associated with a period of sustained economic growth. Until the late 1970s, the economy underwent sustained expansion. By 1978, real profits had increased 53 percent over their level of 1975. Real business fixed investment grew by over 9 percent annually in 1976-78, and real GNP expanded at a 5.3 percent annual rate.

In sum, the experience of the last twenty years demonstrates that raising business taxes now would contribute to slowing down the economy, while retention of the remaining ERTA business tax cuts should contribute to more rapid economic growth during the mid-1980s, as similar tax cuts have in the past.

II. ARGUMENTS AGAINST SPECIFIC OPTIONS FOR REVENUE INCREASES

Of the current options for increasing revenue, one possibility is the Administration's contingency tax plan, which would consist of a $5 per barrel excise tax on oil and a tax surcharge on business and individuals. This tax, however, would only go into effect if certain preconditions are satisfied with regard to both spending cuts and the then state of the economy. The revenue gains would be in the area of $140 billion over the period fiscal years 1985-1988. Another option is the "tax freeze" proposal, which would raise comparable revenues (about $130 billion over fiscal years 1985-1988). No other specific proposals are pending, although it is certainly conceivable that the Congress could craft another revenue increase bill similar to TEFRA, raising taxes by changes in numerous and diverse provisions of the tax laws.

The generic arguments against increases in business taxation apply to both the contingency tax and the tax freeze. In addition, there are specific problems with each. The contingency tax would be inequitably distributed among corporations, since it would effectively penalize those that are highly productive and profitable and already paying high effective rates. The tax freeze would repeal indexation of individual tax rates, and would therefore allow unlegislated tax increases through "bracket creep" (except in the event that prices were completely stable, a relatively unlikely possibility).

A more important consideration, however, is that since both of these proposals would raise future taxes, there would be considerable risk to the economy associated with enacting either of them at the present time. The rationale for now enacting a tax increase applicable to future years is that the outyear deficits constitute a threat both to the sustainability of the recovery and to financial stability. Following this line of argument, because the deficits represent a substantial claim on available credit, they will deprive business of access to working capital, and will constitute a source of upward pressure on interest rates. NAM concurs that the deficits represent a major risk to the recovery, but does not believe that this justifies immediate revenue increases.

To begin with, the threat posed by the deficit must be balanced against the threat to recovery arising from tax increases. In this respect, it should be borne in mind that the adverse implications of the deficit are fundamentally long-term in nature: the deficit is unlikely to raise interest rates by significant magnitudes until a much later stage in the business cycle. In the short term, the impact of the deficit on economic activity is stimulative.

Conversely, tax increases tend to exert an immediate contractionary effect on economic activity. For this reason, the timing of tax increases over the business cycle is of criitical importance to their effects on the economy. If taxes are raised during a period of recession or slow growth, they will tend to produce greater economic slack and perpetuate higher unemployment. In the event that taxes were to be raised this year but the increases were not to take effect until future years, this would require acutely accurate foresight on the part of Congress as to the probable condition of the economy at the time the increases are scheduled to go into effect. In our view, there is insufficient grounds for assuming that the recovery will have progressed to the degree that it will be able to withstand higher taxes by fiscal year 1986, the year in which the Administration's proposed contingency tax would take effect and in which the tax freeze proposal would first begin to have major impact. In NAM's most recent study on the economic outlook, the recovery is projected to slacken off by late 1984. If the contingency tax or tax freeze proposal were to be enacted now, the result could be to raise taxes at a time when the economy will be lapsing into a period of slower growth. Clearly, this would represent the wrong stage in the business cycle for tax increases. Raising taxes at the wrong stage in the business cycle, in the final analysis, is likely to lead to a slowdown or contraction in the growth rate and for this reason does not guarantee a reduction in the deficit.

In sum, extreme caution should be applied with respect to any bill which would raise taxes at some future time, since it is not always possible to guage the condition of the economy at the time when the higher taxes take effect. Under the circumstances, Congress should defer consideration of any major revenue bills until such time as it appears the economy can sustain such an increase. In the event that the performance of the economy is less than robust over the next few years, Congress should not adopt any tax increases, but rather should preserve the recent and scheduled upcoming tax reductions in full.

A final argument against enacting either the contingency tax or the tax freeze proposal at the present time is that they are both essentially temporary expedients, rather than systematic reforms of the tax system. In the event that Congress enacts legislation substantially altering the tax laws, such a bill should address deficiencies in the current tax laws on a systematic basis, and should produce a more efficient tax structure that is more commensurate with stable economic growth. Neither the contingency tax nor the tax freeze proposal meet this criterion; both represent ad hoc mechanisms for reducing the deficit. For this reason, there exists little grounds for enacting either proposal in the absence of compelling evidence that deficit reduction is an urgent short-term priority. In the absence of such evidence, enactment of either proposal would merely serve to introduce distortions into the tax code. In this regard, the tax freeze proposal would be particularly undesirable since it would perpetuate deficiencies in the tax code that ERTA was designed to eliminate, such as the failure of individual tax brackets to take account of inflation.

Because neither the contingency tax nor the tax freeze constitutes a satisfactory means of addressing the deficit issue, Congress may wish to consider longer run reform of the tax system as part of any effort to achieve smaller deficits. In this respect, a major long run problem with the American tax code has been its tendency to penalize savings and investment while subsidizing or otherwise rewarding consumption.

The treatment of savings versus consumption in the American tax system is highly atypical of tax codes throughout the industrial countries. Most of the major industrial countries derive a substantial share of their revenue from consumption taxes, most commonly through value-added taxes levied at the successive stages of production. The result is that although the ratio of tax revenues to national income is lower in the United States than in all of the major industrial countries except Japan, the share of revenue derived from direct income taxes (as opposed to indirect consumption-based taxes) in the United States is one of the highest in the industrial world.

The experience of the other industrial countries suggests that there are certain advantages to be gained by taxing consumption rather than income. Because the tax codes of other countries do not penalize investment to the same degree as the United States, these countries generally exhibit a higher level of personal savings and a higher ratio of capital formation to GNP. Increasing personal savings is important because it raises overall liquidity and permits the financing of government deficits without extensive upward pressure on interest rates. A higher level of capital formation is frequently associated with higher productivity growth. At the same time, indirect taxation of consumption rather then direct taxation of income may provide less of an incentive for individuals to seek access to tax shelters.

Examples of consumption-based taxes which might be applicable in the United States include either a value-added tax comparable to similar taxes in Western Europe, or a national sales tax. Another alternative is to convert the present income tax system into a consumed income tax by excluding from income taxation the net amount put into savings or investment. The NAM does not at this time endorse or recommend any particular type of consumption tax, but we do think that Congress should seriously consider the possibility of making major structural revisions in our tax laws which would shift the incidence of taxation away from savings and investment, in lieu of making further patchwork revisions to an already unwieldy income tax system.

III. CONCLUSIONS

NAM opposes any increases in general revenue taxation at the present time, meaning both fiscal year 1984 and fiscal year 1985. In this regard, we are in accord with what we understand to be the position of the Administration regarding the timing of any tax increases. An immediate tax increase would reduce aggregate demand, slow the economy and seriously jeopardize the recovery. Because of the extreme losses in corporate profitability and liquidity during the recent recessionary period, any increase in business taxation would further undermine the financial solvency of the corporate sector. Ultimately, this would translate into lower capital formation and higher unemployment. Apart from short run considerations, there are a series of generic arguments against raising business taxes, among them the inequitable distribution of costs and benefits under recent tax legislation, excessive taxation of corporate income throughout the last decade, and the successful results achieved by business tax cuts in the past.

While we agree that tax increases may ultimately prove neccessary in fiscal year 1986 and later fiscal years, we think that the uncertainties in predicting the state of the economy at that time indicate that Congress should wait until at least 1985 before determining whether it should enact taxes for such years. The Congress could use the interim period to an advantage studying alternative methods of taxation which could go a long way towards eliminating both the incredible complexity and the unfortunate anti-capital formation bias of the present income tax system.

Chairman ROSTENKOWSKI. Dr. Albertine, you may proceed.

STATEMENT OF JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, ON BEHALF OF THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

Mr. ALBERTINE. Thank you very much. I am John Albertine, president of the American Business Conference, a coalition of midsize high-growth companies. Today I testify as chairman of the Coalition To Reduce High Effective Tax Rates. This coalition was formed less than 2 months ago by associations and corporations that are concerned about the long-term effects that high-effective business tax rates will have on economic growth and the more immediate effects that certain proposed tax increases would have on businesses that already pay such rates.

The committee's hearings on revenue increases for fiscal year 1984 through fiscal year 1986 are our first opportunity to discuss the purposes for, and objectives of, the coalition.

The following statement presents in summary form the existing information that documents the high-effective tax rates paid by many businesses. It also explains the reasons for our very strong opposition to the enactment of a surtax as a method for increasing taxes to meet the reconciliation requirements since companies with very low-effective rates would be virtually untouched.

The long-term objective of the coalition is to reduce high-effective tax rates, whether undertaken as a legislative initiative within the income tax system or as part of a fundamental restructuring of all Federal tax systems.

I would like to just summarize the statement and submit the statement for the record.

Chairman ROSTENKOWSKI. Without objection, it is so ordered.

Mr. ALBERTINE. The first point we wish to make is that the Coalition to Reduce High Effective Tax Rates represents some of the best entrepreneurial companies in America, companies like Dunkin' Donuts, for example, which during the recession grew at a compound rate of more than 20 percent, or Shared Medical Systems, which grew at more than 40 percent a year, or IBM, which is a world class competitor.

These are the firms in America which are creating new industries, creating new jobs, and which are essential to this economy if we are to bring down the rate of unemployment over the next several years, Mr. Chairman.

Second, two widely quoted corporate tax rate studies that list the low-effective tax rates paid by some industries and companies, that is, 10 percent, 5 percent, or even negative rates, also document very much higher rates paid by many industries and companies including our members.

Unfortunately, the latter facts have been neglected. This contributed to a public perception that businesses generally pay low rates of tax.

Third, effective income tax rate studies do not take into account the mounting employment tax liabilities of the 1970's and 1980's. Neither do they consider that many mid-size and small businesses, most of which are unincorporated, are subject to individual income tax rates of up to 50 percent.

Fourth, a surtax, such as the one which has been proposed by the administration as a contingent tax increase mechanism for fiscal year 1986, would be unjustifiably inequitable. Rather than being subject to a simple and uniformly applicable tax, those companies already paying high-effective income tax rates would be severely penalized by a surtax while other financially profitable companies with very low-effective rates would be virtually untouched.

Fifth, the long-term objective of the coalition is to reduce high-effective tax rates, whether undertaken as a legislative initiative within the income tax system or as part of a fundamental restructuring of all Federal tax systems.

Sixth, I would like to address myself to a point repeated again and again in Washington and around the country with respect to the issue of crowding out. There is no question but that huge Federal deficits over a long period of time have the effect of crowding out private borrowing for purposes of investment in plant and equipment, in new industries, and new jobs.

But I think it is important to remember, Mr. Chairman, that if the Congress of the United States tries to deal with the problem of crowding out of private investment by raising corporate income taxes it will, by definition, crowd out private investment. It does us no good to crowd out private investment by raising corporate income taxes in order to prevent the crowding out of private investment as a result of the huge deficits.

We feel very strongly that raising corporate income taxes to deal with this problem would, in fact, not achieve the desired end.

Seventh, with respect to the corporate income tax itself, there are two very serious problems with it. It is, first of all, fundamentally a tax on production. Most of the corporate income tax is shifted back to the form of lower rates of return to stockholders and lower wages to workers. In that sense, it is a tax on production.

Mr. Chairman, the fundamental problem we have in this country is the problem of increasing production.

Furthermore, we are convinced that the uneven distribution of the corporate tax which is documented in our discussion this morning, is a serious barrier to economic growth, because it has the effect of artificially skewing relative rates of return to various firms in this economy. It leads to a misallocation of resources and, therefore, the unevenness of the distribution of the tax is itself a barrier to economic growth.

Eighth, Mr. Chairman, the American Business Conference recently commissioned a study done by the chairman of the Thermo Electron Corp., Dr. George Hatsopoulos, of the relative cost of capital in the United States versus Japan. Our numbers show that the cost of capital in the United States is about three times as high as the cost of capital in Japan, and even liberal economists like Paul Samuelson have publicly testified that our numbers are correct.

In our view, our fundamental problem with respect to international competition is lowering the cost of capital in the United States. Certainly, raising corporate income taxes by a surtax mechanism, for example, would have the opposite effect.

Mr. Chairman, if you would look at the numbers in that study, you find that the high-tech sector in America is in about the same position as the basic industries were in about 1965. Our numbers show, for example, that given the relative cost of capital in the United States versus Japan, the same 10-year project undertaken here as in Japan requires a probability of success five times as high as it does in Japan.

Now, we are not five times better than the Japanese. That means that unless we get the cost of capital down, the high-tech sector here is in for the same treatment that the basic industries have gotten from the Japanese and others in the last 15 years.

So, in summary, Mr. Chairman, we think it is a serious mistake to try to deal with the problem of these deficits, the problem of crowding out, by raising corporate income taxes through the surtax mechanism.

Thank you.

Chairman ROSTENKOWSKI. Thank you very much.

[The statement of Mr. Albertine follows:]

STATEMENT OF JOHN M. ALBERTINE ON BEHALF OF THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

SUMMARY

(1) The members of the Coalition to Reduce High Effective Tax Rates are listed in the Appendix. Representing more than 500,000 businesses including approximately 70 of the Fortune 500 industrial corporations, we are concerned about the widespread perception that businesses in general pay very low taxes.

(2) Two widely quoted corporate tax rate studies that list the very low effective tax rates paid by some industries and companies, e.g. 10 percent, 5 percent or even negative percentages, also document very much higher rates paid by many industries and companies, including Coalition members. Unfortunately, the latter facts have been neglected. This has contributed to a public perception that businesses generally pay low rates of tax.

(3) Effective income tax rate studies do not take into account the mounting employment tax liabilities of the 1970s and 1980s. Neither do they consider the midsize and small businesses, most of whom are unincorporated and are subject to individual income tax rates of up to 50 percent.

(4) A surtax, such as has been proposed by the Administration as a contingent tax increase mechanism for fiscal year 1986, would be unjustifiably inequitable. Rather than being subject to a simple and uniformly applicable tax, those companies already paying high effective income tax rates would be severely penalized by a

surtax while other financially profitable companies with very low effective rates would be virtually untouched.

(5) The long-term objective of the Coalition is to reduce high effective tax rates, whether undertaken as a legislative initiative within the income tax system or as part of a fundamental restructuring of all federal tax systems.

STATEMENT

Thank you, Mr. Chairman. My name is Jack Albertine, and I am President of the American Business Conference. Today, I am testifying as Chairman of the Coalition to Reduce High Effective Tax Rates.

This Coalition was formed less than two months ago by associations and corporations that are concerned about the long-term effects that high effective business tax rates will have on economic growth and the more immediate effects that certain proposed tax increases would have on businesses that already pay such rates. The Committee's hearings on revenue increases for fiscal year 1984 through fiscal year 1986 are our first opportunity to discuss the purposes for, and objectives of, the Coalition.

The following statement presents in summary form the existing information that documents the high effective tax rates paid by many businesses. It also explains the reasons for our very strong opposition to the enactment of surtax as a method for increasing taxes to meet the reconciliation requirements of the first concurrent budget resolution for fiscal year 1984. In addition, we briefly describe our initial membership and outline the research and informational activities that have begun.

I. Summary of principal points

(1) The members of the Coalition to Reduce High Effective Tax Rates are listed in the Appendix. Representing more than 500,000 businesses including approximately 70 of the Fortune 500 industrial corporations, we are concerned about the widespread perception that businesses in general pay very low taxes.

(2) Two widely quoted corporate tax rate studies that list the very low effective tax rates paid by some industries and companies, e.g. 10 percent, 5 percent or even negative percentages, also document very much higher rates paid by many industries and companies, including Coalition members. Unfortunately, the latter facts have been neglected. This has contributed to a public perception that businesses generally pay low rates of tax.

(3) Effective income tax rate studies do not take into account the mounting employment tax liabilities of the 1970s and 1980s. Neither do they consider the midsize and small businesses, most of whom are unincorporated and are subject to individual income tax rates of up to 50 percent.

(4) A surtax, such as has been proposed by the Administration as a contingent tax increase mechanism for fiscal year 1986, would be unjustifiable inequitable. Rather than being subject to a simple and uniformly applicable tax, those companies already paying high effective income tax rates would be severely penalized by a surtax while other financially profitable companies with very low effective rates would be virtually untouched.

(5) The long-term objective of the Coalition is to reduce high effective tax rates, whether undertaken as a legislative initiative within the income tax system or as part of a fundamental restructuring of all federal tax systems.

II. High effective rate business taxpayers

An "effective income tax rate" is commonly computed by dividing the amount of taxes paid by the amount of net income reported to shareholders. If two companies both have net financial incomes of $1,000 but one pays $400 in taxes and the other pays $100 in taxes, their effective tax rates are 40 percent and 10 percent respectively. Thus, a company's effective tax rate is determined by the relative size of its tax paid and its net income, not the absolute dollar amount of its tax paid by each. Therefore, both a very profitable company that operates in a low profit margin industry and a barely profitable company in a distressed industry can have high effective rates while an enormously successful company that realizes generous profit margins can pay a low effective rate due to full utilization of existing tax provisions.

Perennial congressional and press attention is given to effective tax reports. Industries and specific companies that pay very low rates in relation to the statutory 46 percent corporate income tax rate are highlighted. Recent congressional hearings on taxation of banks and thrift institutions have drawn renewed attention to the subject.

Many of the companies and industries that are the subjects of such studies are listed as paying less than one-half of the 46 percent rate, i.e., 23 percent or lower. A significant number are listed as paying less than one-fourth of the statutory rate, i.e., less than 11.5 percent. Some are even shown to pay negative tax rates due to tax provisions that produce loss carryforwards for tax purposes while reporting net income to shareholders.

It is certainly correct that many industries and many major corporations utilize a series of deductions, exemptions and credits to reduce their effective corporate income tax rates. But it is also correct, although almost always overlooked, that many industries and major corporations pay much higher rates than their more widely publicized counterparts at the low end of the scale. The lack of attention to these taxpayers has allowed an incorrect and troubling public perception to grow that businesses generally and major corporations in particular escape federal taxation.

If the Committee initiates a major tax increase bill this year, a number of myths should be exposed and neglected facts must be considered in order to understand existing business tax burdens and how particular tax increases would affect those burdens.

A. Numerous industries and major corporations pay high effective income tax rates.—Although public attention is directed to the low-rate examples, two effective corporate tax rate studies that are published annually also provide extensive information regarding high effective rate industries and corporations. Tax Notes, which is published weekly by Tax Analysts of Arlington, Virginia, has prepared effective corporate tax rate tables for various industries for several years. In the 1982 Tax Notes special supplement entitled "Effective Corporate Tax Rates in 1981," Appendix A lists 31 industry groups and their effective rates based on the Fortune 500 corporations that were surveyed. Of the 31 groups, there were 14 that had an average 1980–1981 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (i.e., was greater than 23 percent). Those industries are the following: Apparel [1]; beverages; diversified service industries; food processors; industrial and farm equipment; instrument companies; office equipment; pharmaceuticals; publishing and printing; retailers, food; retailers, nonfood; soaps and cosmetics; textiles and vinyl flooring [1]; tobacco.

The corporate effective rate study for 1981 prepared by the Staff of the Joint Committee on Taxation and by the Government Accounting Office for Representative Pease and Representative Dorgan (formerly for Representative Vanik), reprinted in the Congressional Record for December 20, 1982, beginning at page H 10545, listed 22 industry groups using different classifications than those in Tax Notes. Also using somewhat different computational methodologies, the Pease-Dorgan study lists 11 industries that had an average 1980–1981 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (i.e., was greater than 23%). Those industries are the following: Beverages [2]; Diversified services [2]; electronics, appliances; food processors [2]; motor vehicles; office equipment [2]; oil and refining; Pharmaceuticals [2]; retailing [2]; tobacco trucking [2].

At this time, the Coalition is neither endorsing the methodologies employed by Tax Notes or by the Staff of the Joint Committee on Taxation in their preparation of these reports nor ratifying their findings. As has been noted over a period of years, there are a number of tax accounting judgements used in the two studies on which differing views are held. Furthermore, the use of financial data contained in reports filed with the Securities and Exchange Commission may or may not provide the best means for computing such rates.

The Coalition is initiating a review of these widely respected annual studies and of any other available information to determine what, if any, additional or different research needs to be undertaken. We anticipate the preparation of an extensive review and commentary on the entire subject at a later date.

However, while we are not yet prepared to comment on the methodologies and findings of the two ongoing studies, we are quite confident that one very simple but significant observation can be made now. It is a point that has been virtually ignored for reasons that are not apparent to us. That is—

The two annual reports that are pereannially cited for their data regarding low effective corporate income tax rates paid by large corporations also present extensive statistical information documenting the widespread nature of high effective income tax rates paid by other large corporations.

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[1] The 1981 rate exceeded 23 percent. The industry was not included in the 1980 study.

[2] The "x" indicates groups that are on both the Pease-Dorgan list and the Tax Notes list above.

Therefore, to the extent that the findings of such studies have troubled members of this Committee who are concerned about low effective corporate tax rates, the additional information therein regarding much higher effective rates should not be allowed to remain unnoticed. The credibility which has been developed by these studies over a period of years should attract attention to both the low and the high effective tax rate data.

But even an expanded reading of these studies does not present a complete description of the disparities of tax rates among businesses. A number of factors have not been taken into account. These are briefly discussed in the next sections.

B. Effective tax rate studies have not considered the vast number of midsize and small businesses.—The Tax Notes and Pease-Dorgan studies have focused exclusively on major corporations, due to the necessity for using required SEC reports as the sources for the data that are used to make the calculations. In fact, the Pease-Dorgan study of 1981 rates by industry classification considered only 179 of the Fortune 500 industrial companies and the Fortune 50 non-industrials. The Tax Notes study for 1981 surveyed 514 leading U.S. firms from the Fortune 500 industrial companies and the Fortune 50 non-industrial companies, supplemented by additional companies from the Fortune second 500 to offset others that experienced losses and, therefore, were not subject to federal income tax.

The necessity for surveying only the largest corporations quite probably results in an understatement to some degree of the overall effective rate for an industry as a whole because the largest companies in an industry are more likely to expend the resources necessary to maximize the benefits of existing tax provisions than are their midsize competitors. This is particularly likely in the distribution services such as wholesale distribution (which has not been studied by either of the two annual reports) and retailing (where vast numbers of businesses are located in income levels just below the few very large companies that have been studied).

Preliminary support for this view is contained in data used for a study prepared for the American Business Conference by McKinsey & Company, Inc. During its two-year inquiry into the reasons that midsize growth companies outpace businesses generally with respect to sales, profits, jobs and exports, McKinsey & Company compiled and studied tax information on American Business Conference members and on 1,893 midsize and large companies for the 1977 through 1981 period. The data, provided by Compustat, indicate that effective corporate tax rates by industry groups probably are slightly understated when only the largest corporations are included because the midsize firms tend to pay slightly higher rates. For example, the McKinsey data indicate federal corporate income tax rates during the period for large retailing and wholesale distribution companies of 32.3 percent and 33.2 percent respectively while midsize companies in these two industries paid rates of 35.2 percent and 36.1 percent respectively.

The Coalition is planning to analyze the data for compatibility with the Tax Notes and Pease-Dorgan studies and to break down McKinsey's single "manufacturing" category into much more extensive classifications. Our initial reaction is that the nature of a company's business has a much greater impact on effective tax rates than does its size.

C. Effective income tax rate studies do not consider the mounting burden of payroll taxes.—The labor-intensity of those industries listed above tends to be higher—much higher in many cases—than the sectors benefitting from low effective income tax rates. Thus, their employment tax burdens, particularly Social Security taxes, have grown dramatically since the early 1970s. Starting at $100 billion in 1967, social insurance taxes (more than 85 percent of which is Social Security tax) are climbing to an estimated $300 billion in 1987. But this very real tax burden is not reflected in the effective income tax rates. For many businesses, particularly smaller companies in service industries, payroll taxes equal or exceed in dollar amounts the federal income taxes paid. Thus, while rarely mentioned, these taxes have become the major tax issue for such businesses.

As part of the review of existing income tax rate studies, the Coalition plans to incorporate the effects of payroll taxes to determine a more realistic overall effective federal tax rate.

D. The vast numbers of unincorporated businesses are never discussed.—High marginal tax rates on sole proprietors and partners, ranging up to 50 percent, exceed even the 46 percent corporate rate. Yet these businesses, to whom the employment tax burdens may be even more important, are not taken into consideration when generalizations are made concerning business tax rates.

This is an additional area that will be reviewed by our working group.

E. Businesses continue to pay very sizable amounts of Federal taxes.—One outgrowth of the attention given to low effective rates appears to be a perception that the corporate income tax has been virtually repealed. Yet the corporate income tax has produced $50 to $70 billion annually from 1976 through 1981 and, after the recessionary trough of 1982 and 1983, is projected by the Congressional Budget Office (CBO) to generate more than $80 billion annually by 1987. Such amounts certainly are not being generated by a business community that pays effective income tax rates of 10 percent, 5 percent, or 0 percent. Instead, they are being paid and will continue to be paid by those industries and companies with much higher effective rates.

Furthermore, more than 50 percent of the mounting social insurance taxes are paid by employers and self-employed individuals, which significantly increases their overall effective Federal tax rate.

Thus, even with incomplete information, it is apparent that significant business sectors pay effective income tax rates, not to mention overall tax rates, that are much higher than the minimal percentages paid by industries and companies that are perennially subjected to intensive public scrutiny.

III. The inequity of a surtax on business

Consideration of effective tax rate burdens is more than an academic inquiry. It is a matter that should have a profound effect on Federal tax policy deliberations. The most immediate concern is the potential enactment of a surtax on businesses, as recommended by the Administration on a contingent basis.

A surtax that applies either to Federal tax liability or to Federal taxable income is often presented as a simple and equitable means for increasing taxes on business because it can apply uniformly to all business taxpayers. This view is probably based to a large extent on that belief that businesses—or at least major corporations—all pay low effective rates of tax and therefore would be rather evenly impacted by a surtax.

But a surtax is not uniformly applicable, for the simple reason that all businesses are not subject to the same or even similar effective rates, as has been outlined earlier. In fact, a surtax would impose the heaviest burden on those firms that already pay the highest effective tax rates while falling much less heavy—if at all—on equally profitable firms that utilize an array of deductions, exemptions and credits to reduce or eliminate taxable income and liability.

Although oversimplified, the following three examples illustrate this point.

VARYING EFFECTS OF A SURTAX

	Company A	Company B	Company C
Corporate tax computation:			
Net financial income	$1,000	$1,000	$1,000
Less tax adjustments for:			
ACRS, depletion, loss reserves, et cetera	($700)	($100)	($100)
Exempt income	0	($500)	0
Taxable income	$300	$400	$900
Tax at 46 percent rate	$138	$184	$414
Less investment tax credit (ITC)	($100)	($15)	($15)
Tax paid	$38	$169	$399
Effective tax rate (percent)	3.8	16.9	39.9
Alternative surtax computations:			
(a) 5 percent of taxable income	$15.0	$20.0	$45.0
(b) 10 percent of pre-ITC tax	$13.8	$18.4	$41.4
(c) 10 percent of post-ITC tax	$3.8	$16.9	$39.9

Although starting with identical financial incomes, the three hypothetical firms are treated much differently for tax purposes. The provisions of the Internal Revenue Code which reduce the taxable incomes and tax liabilities of Company A and Company B have been debated and reviewed over the years. Their benefits have been analyzed at length. Some have been expanded, and some have been curtailed. All have been subjected to prolonged scrutiny. Therefore, they are generally thought to be desirable, to varying degrees.

The issue is not whether any specific deduction, exemption or credit—or any industry-wide grouping of such provisions—is excessive. The Coalition has no intention of suggesting that any specific tax provision be changed as a means of raising someone else's taxes. Our objective is to reduce the high effective rates that our members pay. Repeal of most of the provisions that benefit low effective rate taxpayers would also increase taxes for our members because virtually all businesses utilize one or more of those provisions to some extent.

Rather, the issue that we raise for consideration is the fact that a surtax intensifies the assymmetries in effective tax rates because it falls heavily on those companies and industries that are able to realize only a modest benefit from all existing tax provisions, such as Company C, while falling very lightly on those who already realize massive tax benefits.

CONCLUSION

The Coalition does not have a policy position with respect to enactment of a tax increase bill this year to take effect in fiscal year 1984 and beyond. But an informal survey of our founding members indicates widespread opposition to such a bill. This view is based on a desire to leave the tax system alone for awhile and to allow economic recovery to move ahead without draining more taxes away from the private sector to be spent by the government.

If the Congress does draft a tax increase bill this year, we strongly urge that such legislation take into account the facts presented in our statement. High effective tax rates ensure that a surtax would be grossly inequitable and unjustifiably harsh on the companies and industries that already pay such effective rates. The apparent simplicity of a surtax mechanism masks the widely varying effects that it would have on firms with similar income but widely varying tax rates. Therefore, a surtax should not be enacted either for current or contingent revenue raising purposes.

APPENDIX A

FOUNDING MEMBERSHIP OF THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

American Business Conference; Bristol Myers; Dart & Kraft, Inc.; General Mills Inc.; Grocery Manufacturers of America; IBM Corporation; National Association of Wholesaler-Distributors; National Federation of Independent Business; National Retail Merchants Association; Procter & Gamble Manufacturing Company; Small Business United; 3M Company.

Chairman ROSTENKOWSKI. Mr. Rahn, you may proceed.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY DAVID E. FRANASIAK, MANAGER, TAX POLICY CENTER; AND KENNETH D. SIMONSON, SENIOR TAX ECONOMIST

Mr. RAHN. Thank you, Mr. Chairman. I am Richard Rahn, vice president and chief economist of the Chamber of Commerce of the United States. I am accompanied by Dave Franasiak, director of the Tax Policy Center, and Ken Simonson, our senior tax economist. I will summarize my remarks and request the entire testimony be made a part of the record.

Although the budget resolution passed last month requires tax-writing committees to recommend revenue increases totaling $73 billion over the next 3 years, we are convinced now is not the time to enact new taxes. The economy has begun to rebound robustly from the recession and sustained strong growth will do more than any tax increase to help shrink the deficit.

Conversely, a new round of tax increases will stunt the recovery, particularly if those increases fall mainly on business, as was the case last year.

The chamber is sanguine about the chances of a strong, sustained recovery. Our latest forecast, based on more recent economic data than was used for the budget resolution, projects growth in real gross national product (GNP) of 6.2 percent in 1984 and 5 percent in 1985. We expect the unemployment rate to drop to 8.4 percent in 1984 and 7.5 in 1985. In contrast, the budget resolution assumes lower GNP growth and higher unemployment of about 1 percent each in both years.

The administration and CBO and private forecasters made much lower forecasts. They are revising their forecasts to bring them much more in line with ours.

These differences are important because the deficit is quite sensitive to both the rate of economic growth and the unemployment rate. However, even with growth at the levels forecast by the budget resolution, the deficit is likely to be smaller than the resolution projects.

In each of the last 6 years, the resolution has projected a large deficit than actually occurred whenever the economy grew by more than 2 percent, and a smaller than actual deficit when the economy grew by less or shrank. In years of strong growth, the overestimate ranged from 13 percent to 84 percent of the actual deficit.

On the other hand, attempting to reduce the deficit by increasing tax burdens, particularly on investment, could have dire consequences for the recovery. The Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA] was promoted as a loophole-closing measure, but it had a severe impact on business.

Nearly 60 percent of the revenue came from cutbacks on business, and these changes eliminated more than 70 percent of the tax reductions business received in the 1981 act. Investment was hit especially hard, through provisions like the one-half basis adjustment, repeal of 1985-86 changes, cutback in investment tax credit, and elimination of safe-harbor leasing.

These changes led many firms to abandon investment plans and may help account for the slow recovery that business fixed investment has shown this year, compared to the beginning of most recoveries.

Surprising little remains from the tax relief granted by the Economic Recovery Tax Act of 1981 [ERTA]. ERTA was designed to compensate taxpayers for the erosion in disposable personal income created by inflation and recent tax changes.

ERTA was originally estimated to lower revenues by $749 billion from 1982 through 1986. But recession, falling inflation, and dropping oil prices had cut the figure to $609 billion by the time the fiscal 1984 budget appeared last January.

TEFRA, the gas tax, and more social security tax increases have gobbled up $253 billion of that relief. State and local taxes have already gone up by an estimated $80 billion—based on the change in percent of GNP claimed by these taxes from 1981 to 1983, times forecasted GNP in fisal 1982–86—and new State taxes are being enacted weekly.

If the $73 billion contemplated by the budget resolution is passed, taxpayers will wind up with a net tax reduction of only $11 billion over 5 years, or about 2½ cents per day per person, a far cry from the $1.80 that ERTA was meant to provide.

Congress has relied too heavily on tax increases and not enough on spending cuts to reduce the deficit. There is no case of a country bringing down the budget expense by tax increases. The only way to do that is through sustained growth.

Chairman Rostenkowski proposed last February that a desirable way to raise revenue would be to freeze 14 tax reductions that have been enacted but have not yet taken effect. We supported most of the provisions that would be negated by this freeze and do not believe the rationale for them has disappeared. Therefore, we oppose the proposed freeze.

The most important of these provisions is tax indexing. It protects taxpayers from paying a higher percentage of their income in taxes merely because of inflation.

The freeze would also eliminate indexing of the ceilings for contributions to qualified pension plans. Such a freeze would contribute to the abandonment of plans that has resulted partly from the restrictions enacted in TEFRA. The ceilings should be liberalized, not frozen.

Another indexing-type measure that should be preserved is the exclusion for Americans working abroad.

Other parts of the freeze would strike especially hard at small businesses. Currently, businesses can expense up to $5,000 of investment in equipment and machinery. This amount is scheduled to rise in steps to $10,000 but would be left at $5,000 under the freeze plan. Small businesses are the most likely to benefit from the simplicity of an immediate writeoff instead of having to keep track of an asset's basis over several years. Likewise, small businesses are the likely beneficiaries of a provision that allows an investment tax credit for purchase of used equipment.

We see no need to enact a contingency tax now that would take effect only if certain budget and economic conditions are met but which would create great uncertainty for the next 2 years. The administration fought vigorously and, we thought, wisely, to defend the full 3-year rate cut and tax indexing, but an individual tax surcharge would undo much of the benefit of rate reductions.

A corporate tax surcharge could do even more harm per dollar raised. That is because companies must make investment plans far in advance. Investment cutbacks would occur as soon as the surcharge passed, if not before, even though the tax would not take effect for 2 years. Furthermore, a surcharge has its largest impact on the companies that are already paying the highest effective tax rates.

Tax increases at this time would be misguided and potentially fatal to the nascent economic recovery. If tax increases appear warranted for fiscal 1986, Congress should consider them much closer to that date rather than unnecessarily choking back investment planning now through a premature increase. In the meantime, Congress must be far more diligent about trimming the growth in outlays.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Rahn.

[The prepared statement follows:]

STATEMENT OF RICHARD W. RAHN, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

I am Richard W. Rahn, vice president and chief economist of the U.S. Chamber of Commerce. I am accompanied today by Tax Policy Center Manager David E. Franasiak and senior tax economist Kenneth D. Simonson. I welcome this opportunity to present the Chamber's views on tax increases.

Although the budget resolution passed last month requires the tax-writing committees to recommend revenue increases totaling $73 billion over the next three fiscal years, we are convinced this is not the time to enact new taxes. The economy has begun to rebound robustly from the recession, and sustained, strong growth will do more than any tax increase to help shrink the deficit. Conversely, a new round of tax increases will stunt the recovery, particularly if those increases fall mainly on business, as was the case last year.

GROWTH AND DEFICITS

The Chamber is sanguine about the chances of a strong, sustained recovery. Our latest forecast, based on more recent economic data than was used for the budget resolution, projects growth in real gross national product (GNP) of 6.2 percent in 1984 and 5.0 percent in 1985. We expect the unemployment rate to drop to 8.4 percent in 1984 and 7.5 percent in 1985. In contrast, the budget resolution assumes lower GNP growth and higher unemployment of about 1 percent each in both years, as shown in the table below.

COMPARISON OF CHAMBER AND FIRST BUDGET RESOLUTION FORECASTS

	1984	1985
Increase in real GNP, year over year percent:		
U.S. Chamber	6.2	5.0
First budget resolution	5.1	4.1
Civilian unemployment rate percent:		
U.S. Chamber	8.4	7.5
First budget resolution	9.3	8.5

These differences are important, because the deficit is quite sensitive to both the rate of economic growth and the unemployment rate. However, even with growth at the levels forecast by the budget resolution, the deficit is likely to be smaller than the resolution projects. In each of the last six years, the resolution has projected a larger deficit than actually occurred whenever the economy grew by more than 2 percent, and a smaller than actual deficit when the economy grew by less or shrank. In years of strong growth, the overestimate ranged from 13 percent to 84 percent of the actual deficit, as the table below shows. Thus, we believe a sustained recovery can shrink the deficit by more than $73 billion over three years.

ACTUAL AND PROJECTED DEFICITS, FISCAL 1977–82

[Dollar amounts in billions]

Fiscal year	Increase in real GNP (percent)	Deficit projected by first resolution	Actual deficit	Difference	Projected as percent of actual
1977	5.2	$50.8	$44.9	−$5.9	113
1978	5.0	64.1	48.8	−12.3	131
1979	3.9	50.9	27.7	−23.2	184
1980	0.2	23.0	59.6	36.6	39
1981	1.6	−0.2	57.9	58.1	0
1982	−1.3	38.6	110.6	72.0	35

EFFECTS OF 1982 CHANGES

On the other hand, attempting to reduce the deficit by increasing tax burdens, particularly on investment, could have dire consequences for the recovery. The Tax Equity and fiscal Responsibility Act of 1982 (TEFRA) was promoted as a "loophole-closing" measure, but it had a severe impact on business. Nearly 60 percent of the revenue came from cutbacks on business, and these changes eliminated more than 70 percent of the tax reductions business received in the 1981 act. Investment was hit especially hard, through provisions like the one-half basis adjustment, repeal of 1985–86 changes, cutback in investment tax credit, and elimination of "safe-harbor" leasing. These changes led many firms to abandon investment plans and may help account for the slow recovery that business fixed investment has shown this year, compared to the beginning of most recoveries (see table below). Additional changes in the tax treatment of investment could doom the recovery.

INCREASE IN REAL BUSINESS INVESTMENT IN FIRST YEAR OF ECONOMIC RECOVERY

[Based on quarterly data, seasonally adjusted]

Recovery beginning in year/quarter	Real business fixed investment	Real investment in structures	Real investment in producer's durable equipment
Average of 7 postwar recoveries	8.2	4.9	10.7
1982/Q4 [1]	4.7	−.9	7.4

[1] U.S. Chamber forecast.

TEFRA also failed to bring about a reduction in the deficit. Although the first budget resolution for 1983 envisaged a deficit of $103 billion, it now appears the actual deficit will be double that, in spite of the tax increases enacted pursuant to that resolution. Another round of increases now could be equally self-defeating.

TAX INCREASES HAVE BEEN EXCESSIVE

Surprisingly little remains from the tax relief granted by the Economic Recovery Tax Act of 1981 (ERTA). ERTA was designed to compensate taxpayers for the erosion in disposable personal income created by inflation and recent tax changes. These changes—mainly the 1977 social security amendments and the 1980 windfall profit tax—were forecast (by the fiscal 1983 budget) to raise taxes by $192 billion in 1982–86, relative to the law and rates prevailing at the beginning of 1980.

ERTA was originally estimated to lower revenues by $749 billion from 1982 through 1986. But recession, falling inflation, and dropping oil prices had cut the figure to $609 billion by the time the fiscal 1984 budget appeared last January. TEFRA, the gas tax, and more social security tax increases have gobbled up $253 billion of that relief. State and local taxes have already gone up by an estimated $80 billion (based on the change in percent of GNP claimed by these taxes from 1981 to 1982, times forecasted GNP in fiscal 1982–86), and new state taxes are being enacted weekly.

If the $73 billion contemplated by the budget resolution is passed, taxpayers will wind up with a net tax reduction of only $11 billion over five years, or about two and a half cents per day per person, a far cry from the $1.80 that ERTA was meant to provide. It is small wonder that individuals and businesses alike still feel they are heavily taxed and have not gotten a bonanza from the 1981 act.

The shrinking tax cut

	Fiscal 1982–86 revenue effect [billions]
ERTA	−$609
Windfall profits, social security, other 1980 changes	192
TEFRA, gas tax, social security, other 1982–83 changes	253
State and local tax increases	80
Increases imposed by first concurrent budget resolution	73
Total increases relative to 1980 law and rates	598
Net 1982–86 tax reduction, relative to 1980 law and rates	−11

THE PROPER APPROACH TO DEFICIT REDUCTION

Congress has relied too heavily on tax increases and not enough on spending cuts to reduce the deficit. Currently, outlays as a percent of GNP are at an all-time high of 25 percent. Under the budget resolution, this figure would fall only to 23 percent by 1986. Meanwhile, taxes as a share of GNP would rise from their current 18.7

percent to 20.0 percent, a level exceeded only in the height of the Vietnam war and as a result of high inflation in 1980–82. Even without the $73 billion in new taxes, taxes will remain close to 19 percent of GNP through 1986, which is not a low ratio by historical standards.

The resolution calls for only $12 billion of spending cuts, or 16 cents for every dollar of tax increases. Even this meager amount could be offset if Congress approves additional spending allowed for designated programs by the resolution. In other words, tax increases might be used to finance new spending rather than cutting the deficit under this resolution.

Instead of acceding to the dictates of the budget resolution, we recommend that the Ways and Means Committee make cuts in outlays to bring the ratio of spending to GNP in line with historical levels. We hope that committee members will also support additional spending cuts in other committees and oppose new spending initiatives.

We have been asked to comment on two tax proposals specifically: Chairman Rostenkowski's tax freeze and the Administration's contingency tax.

TAX "FREEZE"

Chairman Rostenkowski proposed last February that a desirable way to raise revenue would be to "freeze" 14 tax reductions that have been enacted but have not yet taken effect. We supported most of the provisions that would be negated by this freeze and do not believe the rationale for them has disappeared. Therefore, we oppose the proposed freeze.

The most important of these provisions is tax indexing, a valuable part of the tax system. It protects taxpayers from paying a higher percentage of their income in taxes merely because of inflation. Although inflation has abated dramatically in the last few years, there is no assurance that it will not surge again. And even moderate inflation has a pernicious effect on marginal tax rates when it cumulates over a period of years. Without indexing, it would take only four years of 5 percent inflation to push a married taxpayer with taxable income initially of $29,000 from a 25 percent to a 33 percent bracket.

Indexing protects low- and middle-income taxpayers. The zero bracket amount and personal exemptions are the largest offsets to income for most of these taxpayers. Indexing keeps their value in line with inflation. Indexing is more useful to these taxpayers than it is to wealthy taxpayer who are already in the top bracket and thus cannot be pushed higher by inflation.

The freeze would also eliminate indexing of the ceilings for contributions to qualified pension plans. Such a freeze would contribute to the abandonment of plans that has resulted partly from the restrictions enacted in TEFRA. The ceilings should be liberalized, not frozen.

Another indexing-type measure that should be preserved is the exclusion for Americans working abroad. Under current law, this is scheduled to rise by $5000 a year until 1986 to provide tax treatment to that of other foreign nationals working abroad. Freezing this exclusion would soon create the same disincentives for sending Americans to work overseas that existed before ERTA.

Other parts of the freeze would strike especially hard at small businesses. Currently, businesses can expense up to $5,000 of investment in equipment and machinery. This amount is scheduled to rise in steps to $10,000 but would be left at $5,000 under the freeze plan. Small businesses are the most likely to benefit from the simplicity of an immediate writeoff instead of having to keep track of an asset's basis over several years. Likewise, small businesses are the likely beneficiaries of a provision that allows an investment tax credit for purchase of used equipment. The eligible amount would rise to $150,000 under current law but remain at $125,000 if a freeze is enacted. Finally, small, closely held businesses and farms will be among the losers if the unified estate tax credit is not allowed to rise for each of the next four years as it would under current law.

ADMINISTRATION TAX PROPOSALS

The Administration's primary tax proposal has been a "contingency tax" consisting of a $5/barrel oil tax and a 5 percent surcharge on both individual and corporate income taxes. The contingency tax would be enacted in 1983 but would not take effect until October 1, 1985. Even then, it would go into effect only if: Congress adopts the Administration's deficit reduction measures (many of which it has already rejected); the unified budget deficit for fiscal 1986 is forecast by the Administration on July 1, 1985, to exceed 2½ percent; and the economy is growing on that date.

We see no need to enact a contingency tax now that would take effect only if certain budget and economic conditions are met but which would create great uncertainty for the next two years. The Administration fought vigorously and, we thought, wisely, to defend the full three-year rate cut and tax indexing, but an individual tax surcharge would undo much of the benefit of rate reductions. For many taxpayers, it would completely eliminate the effect of the 1984 rate cuts, leaving their liability higher in 1986 than in 1983 even with no change in income. Put another way, a 5 percent surcharge would increase liabilities as much as the "bracket creep" caused by current inflation of roughly 3 percent.

A corporate tax surcharge could do even more harm per dollar raised. That is because companies must make investment plans far in advance. Investment cutbacks would occur as soon as the surcharge passed, if not before, even though the tax would not take effect for two years. Furthermore, a surcharge has its largest impact on the companies that are already paying the highest effective tax rates. It especially penalizes labor-intensive companies, retailers, wholesalers, and numerous other industries.

A $5/barrel tax on oil, on top of the windfall profits tax on domestic crude oil, federal and state excises on many petroleum products, and special provisions in many state laws that discriminate against oil producers, would further distort energy markets. The Administration has striven to reduce federal interference with most energy markets. This new tax on a single commodity would be a major step in the wrong direction. (Freezing the present windfall profit tax rate on new oil and the royalty holder's exemption would be similarly misguided.)

For these reasons, we urge the Committee not to consider the contingency tax.

CONCLUSION

Tax increases at this time would be misguided and potentially fatal to the nascent economic recovery. If tax increases appear warranted for fiscal 1986, Congress should consider them much closer to that date rather than unnecessarily choking back investment planning now through a premature increase. In the meantime, Congress must be far more diligent about trimming the growth in outlays.

Chairman **Rostenkowski**. Mr. Pickle will inquire.

Mr. **Pickle**. Thank you, Mr. Chairman.

Within the last 30 days or so, as the chairman said earlier, our interest rates have gone up at least 1 percent and home mortgage interest rates have gone up as much as 2 percent. What has caused this sudden rise in interest rates? Anybody want to volunteer? Mr. Rahn?

Mr. **Rahn**. Well, the rise in interest rates is primarily due to the rapid growth in the money supply. The Federal Reserve has greatly exceeded their own targets. In fact, as of June 2 of this year they exceeded their monetary target for the entire year.

This rapid expansion of a monetary growth has caused inflation fears within the financial markets. We have not had a comparative period of time in the past where you have had such rapid monetary growth without it being followed by rapid inflation. Hence lenders expecting the higher inflation, as a result interest rates rise.

Mr. **Pickle**. I got your point. I am not trying to cut you off. You said the creation of the monetary supply by the Federal Reserve. Anybody else?

Mr. **Cantor**. I will venture an opinion, Mr. Pickle, that the failure of the $700 cap and other signals that have been around——

Mr. **Pickle**. Will you speak into the mike, please?

Mr. **Cantor**. And a lot of other signals around that Congress may not act to increase Federal revenue and do something about the tax reduction-induced deficits might also have something to do with the reactions of the money markets and the increases in interest rates.

Mr. **Pickle**. Pardon me, sir, but would you identify yourself.

Mr. **Cantor**. I am accompanying Mr. Koplan.

Mr. **Pickle**. Would you tell us who you are?

Mr. **Cantor**. Arnold Cantor, assistant director of research, AFL-CIO.

Mr. **Albertine**. I would take vigorous exception to that, Mr. Pickle. It is just not right to believe that people on Wall Street and financial markets generally think it is a good idea to avoid the problem of crowding out by raising taxes, particularly taxes on savings and investment, because the tax increase on savings and investment is, by definition, crowding out of savings and investment and it gets us nowhere with respect to interest rates.

With respect to the cap, to the extent to which those tax reductions are tax reductions to people who would wind up saving, the cap would have had the effect, at least the partial effect, of reducing the pool of savings in this economy. It would have also reduced the demand for loanable funds on the part of the Federal Government, but that is partially offset by the fact that it would have reduced the pool of savings in the economy.

I agree with Mr. Rahn, I think the fundamental point is that the Federal Reserve really had lost control over the growth of money aggregates, and you can see the numbers are clear. That is the fundamental problem we have had.

Mr. **Pickle**. Then you and Dr. Rahn say that the villain in our economic woodpile right now is Paul Volcker, even though most of the talk over the past months indicated he was our savior. Now you say he has now caused high-interest rates.

You said his release of the money causes the interest rate increases. I suspect it may have had something to do with it.

But I am also interested in the point the gentleman made that the third year, failure to cap the third year tax cut may have also caused this rise of interest rates. Maybe half and half. I wanted to get your views on that.

I don't know that I subscribe to Dr. Volcker being the villain. Maybe he is. The latter is more apt to be the reason. I have other questions but we have a lot of witnesses, so let's proceed.

Chairman **Rostenkowski**. Mr. Conable will inquire.

Mr. **Conable**. I would like to ask a question about the repeal of indexing on which he put great stress. It seems to me that indexing is not necessarily in any way related to taxes, but it is a significant reform of primary benefit to working people. It is especially important to people who are sufficiently low on the income scale and who are moving up through the brackets. The result, therefore, is they are constantly giving a bigger cut of their taxes to the government if they get more little pieces of green paper worth less.

It's very significant reform for working people and has no particular benefit for people in the upper brackets.

Thus, I find it fascinating that the AFL-CIO would move to try to deny working people the fruits of collective bargaining by insisting that higher incomes go in greater proportion to the government for no other reason than because of inflation.

Would you comment on that aspect of indexing?

Mr. **Koplan**. Go ahead.

Mr. **Cantor**. Well, I think in the context of these hearings, Mr. Conable, the first and most important thing to consider is that we are here in an effort to raise some money in as painless a manner possible. This to me argues greatly to the advantage of a measure that has not yet gone into effect.

More fundamentally, Mr. Chairman, if you look at the numbers in terms of the most appropriate type of arithmetic on this, that is where people are in after-tax income as a result of indexing, you do find that it is the higher income groups that come off somewhat better through indexing than the lower income groups.

The third point is, again, sort of back to where we are now. I think the money that this would raise is important. I think the money that this would forego would be rather quickly reflected in interest rates, and I think the regressiveness of the rise of interest rates, the effect on what workers can buy and what workers can produce is far more pronounced. If there is a tradeoff I would rather see indexing not enacted and whatever impact on interest rates, salutary impact it would have, I think workers would be better off.

Mr. **Conable**. I just hope you will keep an open mind on this issue for this reason. You mentioned the most painless way of raising money. I think it costs the working man the same pain whether taxes are raised automatically by impact of inflation on the graduated income tax or by an affirmative act of Congress.

Admittedly, it is less painful for the politicians to have money coming in through the back door by way of bracket creep. But I would hope the AFL-CIO would not relate more to the politicians than the working man in respect to the issue of pain.

Thank you. That is all I have to say.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Duncan will inquire.

Mr. **Duncan**. I have no questions, thank you.

Chairman **Rostenkowski**. Mr. Fowler will inquire.

Mr. **Fowler**. Dr. Rahn, is an interest rate rise inevitable with an economic recovery and deficits over $150 billion?

Mr. **Rahn**. Well, if you have very large deficits, your real rate of interest will, of course, increase if your savings rate does not go up. Now, the question is, though, can we make changes which will increase savings rates or bring down the deficit in terms of actually the percentage of net savings, is what we are concerned with.

And if you increase taxes now—particularly in the way you have in the recent past, where most of them come out or a substantial portion of them comes out of savings—you do nothing to increase the total amount of net capital vailable so that would not have a salutory influence on interest rates, yet it would slow down economic growth.

Mr. **Fowler**. The trouble with you or anyone else is if we are not going to decrease the deficit, how is a rise in interest rates going to be prevented, if we have an economic spurt of the magnitude that at least some of the panelists have predicted?

In other words, we all know that you can carry a $300 or $400 billion deficit, I would assume there wouldn't be much disagreement as long as you have a flat economy. You don't have a demand for credit, and they are sitting on what money they have, consumers are not spending, and the magnitude of the deficit is of academic interest. But we don't have too much trouble carrying it in a flat economy.

If you get an economic revival with investment moving, consumers spending, and you still have gargantuan deficits, which is what we have now, will somebody tell me why interest rates are not going to spurt significantly in the coming months?

Mr. **ALBERTINE**. At some point, given these deficits with rapid economic growth, you are going to get rising interest rates. I don't think there is any question. The question is what do you do to reduce the deficits. Are measures you take to reduce the deficits going to have an effect with respect to keeping interest rates down, or are they going to make the problems worse.

Clearly, my own view, not representing this coalition, but representing myself and the American Business Conference, our view is that the key to our long-term economic health is to try to get the percentage of GNP which goes to the public sector reduced.

Second, to the extent to which——

Mr. **FOWLER**. I understand that, and that is good long-run policy that you would find little disagreement with. What I am talking about, I want to know from this panel of experts not only what the prediction is, what is the remedy, if my analysis is not going to be disputed. What is the remedy in the next quarter, the next two quarters? What is to keep a large rise in interest rates and inflation from occurring, given a strong revival in the economy, with very deep deficits.

Mr. **RAHN**. The level of inflation is going to be determined by the Federal reserve policy, what they do in terms of the money supply, and you have two different components in your interest rates. One is inflationary expectations, and the other is the real rate of interest. Now, that real rate has a lot to do with the amount of net capital available.

The other part, of course, just has to do with the rapidity of the growth of the money supply in relationship to the increase in supply of goods and services, and you only have one way out, and that is to reduce the growth rate of Government spending.

We are not talking about cutting the absolute level of Government spending, but reducing its growth rate, so that it is growing slower than private sector economic growth, and if you do that, even with the present tax structure the problem will largely take care of itself.

Mr. **KOPLAN**. Mr. Fowler.

Mr. **FOWLER**. Yes, Mr. Koplan.

Mr. **KOPLAN**. Your point is very well taken. I think the first signal that must be sent must be one that comes from this committee, that we have to take responsible action to raise or come up with revenue-raising proposals of significance, so I think these hearings are most important.

We talked earlier about, for example, indexing. Of course there is a lot of money that will be lost in fiscal 1985 and 1986 as well as the out years if that provision is not repealed. To us, indexing has always been a provision that assumes that the Tax Code is fair.

You can tell from the various list of reforms that we have suggested in our testimony it is not, and we would prefer to look at the specifics of the provisions of the code, rather than to simply make the assumption and to allow indexing to go into effect. So we have always urged against indexing, and in that regard, of course, we support the chairman, who has that as a cornerstone of his freeze proposal.

Mr. **Fowler**. I assume my time is up.

Chairman **Rostenkowski**. Mr. Stark will inquire.

Mr. **Stark**. Thank you, Mr. Chairman.

I welcome the panel. I want to presume that the panel would agree with me that when you talk about savings and investment, that the sense of priorities would be to encourage investment in what we would all generally consider productive assets, lathes, factories, tools of production, research and development that would lead to new products, and that that type of investment is vastly preferable and should be much higher in our priorities than just savings which find their way into yachts and precious metals and race horses and art collections, things that are not productive at all.

Without casting aspersions on people owning them, in tough times our purpose ought to be not to just increase individual personal wealth for frivolous investment but for things which would help the country. Would you all agree with that?

Mr. **Koplan**. Well, when the cut of the top rate from 70 to 50 percent was being debated, that is a point we were making.

Mr. **Stark**. Let me stick my own needles in, Mr. Koplan. I just wondered if anybody had any disagreement with the priorities that I am suggesting.

Mr. **Koplan**. No, no disagreement.

Mr. **Stark**. Then why was it necessary to decrease, or conversely, why should we not, if revenues are short, increase, say, the capital gains rate on collectibles, which do no one really any good, or why not eliminate DISC, which really just sends money overseas to do nothing which is really very productive here as a way of increasing productivity. Why not lower the corporate surtax rate by an amount which would equal doing away with the investment tax credit, and which would give all industries then the same cash flow incentives to move into productive things?

Why do we have to protect these little special interest areas, and why can't we really get about addressing the Tax Code in a way that would direct the productive resources in the manner that the whole panel agrees? Why keep DISC, why keep lower capital gains rates on collectibles, for instance?

[The following letter was subsequently received:]

CHAMBER OF COMMERCE OF THE
UNITED STATES OF AMERICA,
Washington, D.C., July 29, 1983.

Hon. FORTNEY H. STARK,
House of Representatives,
Washington, D.C.

DEAR MR. STARK: During the course of our June 20, 1983, testimony on tax increases before the House Ways and Means Committee, you raised questions concerning the taxation of income of the Domestic International Sales Corporation (DISC) and whether the income tax which may be deferred under the DISC's provisions benefits the U.S. economy. We would like to take this opportunity to respond to those questions for the record.

At one point in our interchange, you said: "if revenues are short . . . why not eliminate DISC, which really just sends money overseas to do nothing which is really very productive here in the way of increasing productivity."

The DISC does not in any way, shape, or form send "money overseas". The DISC as an entity is not subject to income tax on its profits, but rather the shareholders are taxed on these profits. Generally, 57½ percent of the DISC's profits are deemed to be distributed to the shareholders, and they are taxed currently on those profits even though they are not distributed.

Taxation of the remaining income of the DISC is deferred until it is distributed to the shareholders, the shareholder sells his stock, or the corporation no longer qualifies as a DISC. This deferred income is not transferred overseas. It is retained in the DISC, a domestic corporation. Deferred DISC income is used domestically to finance U.S. exports. Increased exports promote manufacture of U.S. products and increases U.S. jobs and capital formation.

The Treasury Department's 1980 Annual Report on DISC (released in December, 1982) states that U.S. exports in DISC year 1980 are estimated to have been $6.2 to $9.4 billion higher than they would have been without the DISC program. Without the DISC these exports would be lost and our balance of trade would be worse than it already is. With the merchandise trade deficit currently exceeding $50 billion on an annual basis, it would be folly to abolish such an effective mechanism for improving the balance of trade.

Moreover, as the Treasury report acknowledges, both the 1981 and the 1982 tax acts have lessened the tax benefits of DISC. Further weakening of DISC will harm our export position. The Chamber would be happy to meet with you to answer any further questions which you may have concerning the operation of the tax rules governing DISC, or its value to U.S. manufacturers.

Sincerely,

RICHARD W. RAHN.

Mr. KOPLAN. We agree with you, and these are some of the very things that we are calling for in our testimony.

Mr. STARK. What about the chamber of commerce on that, Dr. Rahn?

Mr. RAHN. If you got rid of DISC's you would put the American business community in even a greater disadvantage in terms of foreign trade.

Mr. STARK. DISC is absolutely an illegal subsidy. We know it and we are embarrassed at the GATT talks every year. Your premise is absolutely wrong, but go ahead.

Mr. RAHN. DISC is an illegal subsidy by people who have added value taxes which they rebate.

Mr. STARK. They use DISC as the excuse for keeping them.

Mr. RAHN. Do you think if we abolished DISC there would be investment—what about the reciprocity bill?

Mr. RAHN. We would be in a far worse position.

Mr. STARK. Does the Chamber of Commerce support our reciprocity in trade if we drop our tariffs, the Japanese will, too, on semiconductors?

Mr. RAHN. Yes.

Mr. STARK. DISC is the same thing. You can't expect other nations to drop their illegal tax subsidies if we are not willing to do the same thing. Would you agree?

Mr. RAHN. Would you want us to drop ours if they dropped theirs?

Mr. STARK. Remove tax subsidies.

Mr. RAHN. It depends on how far and what they did. Clearly I would go along with tradeoffs.

Mr. STARK. What about the tax on collectibles; would you support an increase on capital gains taxes on collectibles or eliminating them from capital gains treatment to encourage more investment in productive assets rather than in frivolous assets?

Mr. RAHN. If we could agree on definition of collectibles.

Mr. STARK. Gold, platinum, diamond jewelry.

Mr. RAHN. These happen to be minerals and metals that are used in industry. Actually, if we took the capital gains tax completely off those types of commodities and didn't allow capital gains taxes or losses on commodity transactions, that would be relatively neutral to the Treasury and would reduce a lot of distortion.

Mr. STARK. Take away the investment tax credit, too, so we would have a neutral tax code as to all industries?

Mr. RAHN. Take away the investment tax credit? I thought you wanted higher levels of productive——

Mr. STARK. Drop the tax rate by 10 percent, say from 46 to 36 percent, which would be about revenue neutral, eliminating the investment——

Mr. RAHN. What we could do if we wanted to be efficient, we could eliminate the corporate tax to eliminate those distortions.

Mr. STARK. Would you be in favor of that?

Mr. RAHN. Sure.

Mr. STARK. Would anybody else support removing the corporate income tax altogether?

Mr. ALBERTINE. We strongly support that, for some of the reasons you suggest. There is something called the investment efficiency ratio, and it has deteriorated, and I think you make a very good question. The question is how to write the legislation such that you do maximize savings and investment and you don't get a lot of——

Mr. STARK. Jack, the only way we can do that is to get panels such as this to be willing to move with us part way, because as long as you try to keep both ends of the teeter-totter in the air at the same time, this committee is never going to be able to do this. It's efficient and bright lobbyists we see before us today, but we can't get any kind of compromise, or get a willingness to move that first step, and that makes it difficult to get any revenue at all.

Thank you.

Mr. ALBERTINE. We are one group that would be willing to work with you on that.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. I thank you very much.

I was essentially interested in Mr. Albertine's discussion of the Pease-Dorgan tax study. Do you feel, Mr. Albertine, that that study was invalid for any reason?

Mr. ALBERTINE. No. We just would like both parts of the study to get equal attention. There are some firms in this economy that pay very low effective rates, because they are not growing, or because they are growing and they are able, because of the character of their assets to take advantage of various elements of the tax code which lower the rates. But there are also firms in this economy that are paying very, very high effective rates.

For example, the American Business Conference companies, according to a study done for us by McKinsey & Co., have an average effective tax rate of about 30 percent over a 5-year period, so you don't get distortions that you get from looking at taxes on a 1- or 2-year basis.

Our view is simply that the fact that some firms pay high effective tax rates ought to get as much attention as the fact that some firms pay low effective rates.

Mr. **Pease**. Who are you lecturing in that regard?

Mr. **Albertine**. The media.

Mr. **Pease**. As a former newspaperman, I may have to question that the media tend to emphasize negative things like low tax rates rather than high tax rates, and in our study we were very careful to analyze profits by sector, not by individual companies.

We were very careful to emphasize that this first study was a 1-year study, and that we were not drawing conclusions based on that, and we were looking forward to future studies as a basis of finding some trends which then might raise lines of questioning about why the profit levels were higher or lower in sectors, and if anything should be done about it.

Mr. **Albertine**. We would encourage you. You made an excellent beginning. We would encourage you to go forward and we would like to work with you on that.

Mr. **Pease**. Would you be willing to share with us the information that you received on your own members?

Mr. **Albertine**. Yes, sure.

Mr. **Pease**. Thank you very much.

Mr. Chairman, otherwise I would like to compliment the AFL-CIO on its excellent testimony. I thought it was first-class testimony, and I think the burden of their testimony essentially is that if we are mandated by the budget resolution to raise money, and we are, by all means let's do it by closing tax loopholes, rather than on some general tax increase on the citizens.

Most especially, let's try to stay away from regressive tax increases on general citizens, when there are so many tax loopholes available. According to CBO, tax expenditures will result in a decrease in revenue or a loss of revenues to the Federal Government in a range of $340 billion in fiscal 1984, rising to about $410 billion or so in fiscal 1986.

Surely from that universe of—what does that add up to over a 3-year period?—well over $1 trillion in lost revenue—we should be able to come up with $73 billion, which is called for by the budget resolution. I am really very impressed with the testimony and appreciate it.

Mr. **Koplan**. Thank you, Mr. Pease.

Chairman **Rostenkowski**. Mr. Jones will inquire.

Mr. **Jones**. Thank you, Mr. Chairman.

Mr. Chairman, I want to clarify a couple of points. The matters regard Mr. Koplan's testimony. First, you state that the capital gains tax reductions in 1978 and 1980 cost the Treasury $18 billion per year in revenue and primarily benefit the wealthy. All of the indications are that after the 1978 tax bill, that capital gains revenues actually increased to the Treasury.

They did not decrease. In fact, there was a tremendous increase in capital formation, particularly in the venture capital area, and most of the people who look at that attributed it to the decline in capital gains taxes.

Mr. **Cantor**. At that time, Mr. Jones, it is my understanding that there was a release of funds, and therefore an increase in buying and selling activity as a result of a reduction in the rates. But since then—I would have to look at the figures again, but I think you did get a blurp, which happens because of the lock-in effect of the capital gains when released.

But once you get over this blurp, then you have a continuing revenue loss that results from the fact that 60 percent of these profits are excluded from the tax base.

Mr. JONES. What is the source of your study about the $18 billion? I ask that because both the Treasury studies and everything that I have seen indicate that, in addition to the unlocking effect, there has been a gain in Treasury receipts. Furthermore, there has been a tremendous increase in capital formation, due directly to the reduction in capital gains taxes which reversed a continual decline in venture capital for the previous decade.

Mr. CANTOR. The source of our figures on that are both the tax expenditure budget figures which I think are based on the same Joint Committee on Taxation figures as well as the Treasury figures, which show a revenue loss of that magnitude.

Mr. JONES. I don't think it is Treasury, but if you could pin that down a little further——

Mr. CANTOR. We would be happy to submit it for the record.

[The following was subsequently submitted:]

Table G-2. REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION

(In millions of dollars)

Description	Fiscal years		
	1982	1983	1984
National defense:			
Exclusion of benefits and allowances to Armed Forces personnel	2,250	2,200	2,250
Exclusion of military disability pensions	165	165	160
International affairs:			
Exclusion of income earned abroad by United States citizens	985	1,285	1,300
Deferral of income of domestic international sales corporations (DISC)	1,550	1,385	1,080
General science, space, and technology:			
Expensing of research and development expenditures	450	−870	−1,235
Credit for increasing research activities	415	645	685
Energy:			
Expensing of exploration and development costs:			
Oil and gas	3,430	1,520	1,215
Other fuels	25	30	30
Excess of percentage over cost depletion:			
Oil and gas	2,100	1,850	1,665
Other fuels	410	505	530
Capital gains treatment of royalties on coal	205	180	180
Exclusion of interest on State and local government industrial development bonds for certain energy facilities	5	15	20
Residential energy credits:			
Supply incentives	250	430	575
Conservation incentives	360	330	305
Alternative, conservation and new technology credits:			
Supply incentives	205	195	200
Conservation incentives	220	125	25
Alternative fuel production credit	15	40	70
Alcohol fuel credit [1]	5	5	5
Energy credit for intercity buses	10	10	10
Natural resources and environment:			
Expensing of exploration and development costs, nonfuel minerals	50	55	60
Excess of percentage over cost depletion, nonfuel minerals	405	440	470
Exclusion of interest on State and local government pollution control bonds	825	975	1,105
Tax incentives for preservation of historic structures	185	270	310
Capital gains treatment of iron ore	20	20	20
Capital gains treatment of certain timber income	335	370	515
Investment credit and seven-year amortization for reforestation expenditures	10	15	20
Agriculture:			
Expensing of certain capital outlays	545	560	585
Capital gains treatment of certain income	610	615	585
Commerce and housing credit:			
Dividend and interest exclusion	2,160	445	435
Exclusion of interest on State and local industrial development bonds	1,640	2,120	2,520
Exemption of credit union income	150	170	185
Excess bad debt reserves of financial institutions	405	405	635
Exclusion of interest on life insurance savings	4,535	4,805	4,170
Deductibility of interest on consumer credit	10,825	10,765	10,540
Deductibility of mortgage interest on owner-occupied homes	23,305	25,065	27,945
Deductibility of property tax on owner-occupied homes	8,360	8,765	9,535
Exclusion of interest on State and local housing bonds for owner-occupied housing	905	1,110	1,290
Capital gains (other than agriculture, timber, iron ore and coal)	18,020	15,890	16,615
Deferral of capital gains on home sales	1,625	1,480	1,740
Exclusion of capital gains on home sales for persons age 55 and over	585	535	630

Table G-2. **REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION—Continued**

(In millions of dollars)

Description	Fiscal years		
	1982	1983	1984
Carryover basis of capital gains at death	1,995	2,180	2,370
Investment credit, other than ESOP's, rehabilitation of structures, energy property, and reforestation expenditures	16,455	12,985	14,585
Safe harbor leasing rules	3,333	2,990	2,795
Amortization of start-up costs	75	120	180
Exclusion of interest on certain savings certificates	935	1,665	320
Reinvestment of dividends in public utility stock	130	365	415
Transportation:			
Deferral of tax on shipping companies	25	30	40
Exclusion of interest on State and local government industrial development bonds for mass transit	*	5	15
Community and regional development:			
Five-year amortization for housing rehabilitation	45	55	65
Investment credit for rehabilitation of structures (other than historic)	250	335	365
Education, training, employment, and social services:			
Exclusion of interest on State and local student loan bonds	100	155	220
Parental personal exemption for students age 19 or over	1,070	995	950
Exclusion of employee meals and lodging (other than military)	655	680	725
Employer educational assistance	40	40	20
Exclusion of contributions to prepaid legal services plans	20	25	25
Investment credit for ESOPs	1,390	1,250	1,375
Deductibility of charitable contributions (education)	835	775	840
Deductibility of charitable contributions, other than education and health	7,595	7,145	7,190
Credit for child and dependent care expenses	1,175	1,520	1,765
Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	40	*	....
General jobs credit	80	25	*
Targeted jobs credit	235	290	465
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	16,365	18,645	21,300
Deductibility of medical expenses	3,945	3,105	2,630
Exclusion of interest on State and local hospital bonds	680	865	1,055
Deductibility of charitable contributions (health)	1,245	1,170	1,205
Tax credit for orphan drug research	....	10	15
Income security:			
Exclusion of social security benefits:			
Disability insurance benefits	1,780	1,690	1,660
OASI benefits for retired workers	14,825	15,685	16,680
Benefits for dependents and survivors	3,725	3,765	3,870
Exclusion of railroad retirement system benefits	790	780	735
Exclusion of workmen's compensation benefits	1,730	1,870	2,090
Exclusion of special benefits for disabled coal miners	185	170	165
Exclusion of untaxed unemployment insurance benefits	2,500	3,260	3,020
Exclusion of disability pay	155	145	135
Net exclusion of pension contributions and earnings:			
Employer plans	45,280	49,700	56,560
Plans for self-employed and others	2,835	3,755	4,230
Exclusion of other employee benefits:			
Premiums on group term life insurance	2,035	2,100	2,250
Premiums on accident and disability insurance	120	115	120
Income of trusts to finance supplementary unemployment benefits	10	5	5
Additional exemption for the blind	35	35	35
Additional exemption for elderly	2,385	2,365	2,410
Tax credit for the elderly	135	135	135

Table G-2. **REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION—Continued**

(In millions of dollars)

Description	Fiscal years		
	1982	1983	1984
Deductibility of casualty losses	920	575	380
Earned income credit [2]	455	385	330
Exclusion of interest on State and local housing bonds for rental housing	395	530	710
Deduction for motor carrier operating rights	140	75	75
Deduction for certain adoption expenses	10	10	10
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,855	1,825	1,830
Exclusion of veterans pensions	330	310	295
Exclusion of GI bill benefits	180	150	130
General government:			
Credits and deductions for political contributions	180	190	200
General purpose fiscal assistance:			
Exclusion of interest on general purpose State and local debt	6,885	8,000	9,105
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	19,160	20,060	21,770
Tax credit for corporations receiving income from doing business in United States possessions	1,375	1,245	1,075
Interest:			
Deferral of interest on savings bonds	135	435	475

[*] $5 million or less. All estimates have been rounded to the nearest $5 million.

[1] In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of $55 million in 1982, $80 million in 1983, and $90 million in 1984.

[2] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays is: 1982, $1,280 million; 1983, $1,205 million; 1984, $1,125 million.

Mr. JONES. The second thing, in one part of your testimony you talk about the fact that ACRS was responsible for wiping out corporate income tax. And in another part of your testimony you talk about the fact that ACRS hasn't had any effect on increasing capital investment, that capital investment is down. It has been for the last 2 years.

Every year of this administration capital investment has gone down. Capital investment this year will be at the rates of about 1978. That is due, however, to the real rates of interest. The real rates of interest have offset the incentives of ACRS. Therefore, it is inconsistent to say that ACRS is responsible for lowering the corporate tax receipts and at the same time saying it hasn't helped capital investment, because you don't get tax reductions unless you invest.

Mr. CANTOR. Sir, I see that somewhat as a circle in the fact that there was such a great revenue loss due to ACRS, which in turn had an effect on the budget deficit, and on the distribution of resources. This in turn helped increase interest rates which more than wiped out any incentive effects.

Mr. JONES. Then the other part of your statement would be incorrect. If you had a tremendous revenue loss, because of ACRS, you would also have to have a tremendous increase in capital investment.

Mr. CANTOR. I don't understand that.

Mr. **Jones**. You don't get the benefits of ACRS unless you have capital investments.

Mr. **Cantor**. No, you get the benefits of ACRS for normal, routine investment, which always goes on in the economy. I think the point is there were no appreciable obviously incremental effects from ACRS, so therefore companies with routine, normal everyday investments still got an added windfall break, which was a revenue loss.

Mr. **Jones**. Then capital investment wouldn't be down so low. It wouldn't be decreasing each year if your thesis was correct.

Mr. **Cantor**. There are other economists even on the other side of me who will argue that these things take place at the margin, and what happened was that ACRS applies to all investment whether it is over and above what would have been done otherwise or not, and therefore you are talking about net increases. The figures make this obvious. Investment has been down over the past 2 years.

Mr. **Jones**. What is the source of your study?

Mr. **Cantor**. The figures on investment, the tax expenditure figures on ACRS, the obvious look at the way the law works. ACRS does not work on net additional investment. It applies to all investments. It is not a study. It is an observation of fact.

Mr. **Jones**. I think that is an inconsistent statement. I applaud the overall testimony. I just wanted to clear up what I think is an obvious, or two obvious, inconsistencies in your testimony. But I think the basic thrust of your statement is accurate. I really can't understand those who say that the deficits really don't matter and don't relate to interest rates and so forth. I think we have to raise revenue and reduce spending.

Chairman **Rostenkowski**. Mr. Campbell will inquire.

Mr. **Campbell**. Thank you, Mr. Chairman.

I was interested in the difference of opinion, regarding the specifics that Mr. Jones talked about. I was also interested in the difference of opinion that evidently comes forward from this testimony, without singling anyone out.

Let me ask Mr. Rahn this. There seems to be an assumption in some of the testimony that the lack of taxes causes deficits. That doesn't seem to be your assumption, Mr. Rahn. Your assumption seems to be essentially that the spending causes the deficits, and that the taxes in the past may have inhibited some of the growth that we are now beginning to see, because of some of the action that was taken in the past. Is that correct?

Mr. **Rahn**. That is quite correct. In fact, if you look just on a static basis, you find that taxes are down about 1 percent of GNP, which would, you have assumed taxes have had no disincentive on the economy at all, which of course would be a ridiculous assumption, but even assuming that then the portion of the deficit resulting from the tax reduction couldn't be more than $35 billion. The problem is spending has been going up as a percentage of GNP.

I would just like to get back to Mr. Jones' statement there briefly, that if you actually look at Treasury receipts on the capital gains tax you find that they have gone up far more than they had been originally projected.

It is also interesting to note that once we started increasing the capital gains tax in 1969, Treasury receipts went down in constant dollars. Finally, I would like to point out that ACRS is no longer listed as a tax expenditure.

Mr. JONES. Mr. Rahn, let me ask you something else. Your testimony contains a table that I have some interest in. The table attempts to show that when the economy is growing by more than 2 percent, as we've seen in the last 6 years, that the projection has been for a higher deficit than actually took place. Yet when it has grown at a lesser rate, the reverse has happened.

This seems to be a pattern, and as I understand it, you are saying then that your projection for the growth of the economy is now running in about a 1 percent higher level than anything that we are using, or that we actually used, in the budget resolution. With that 1-percent increase in growth, and also with your figures on the unemployment rate, which also is different, I wonder if you could again tell us exactly what the revenue impact is going to be?

Mr. RAHN. Well, there is probably no area where economists, regardless of political persuasion, have been more wrong than in projecting budget deficits, because it is a residual of so many different factors. But I would not be the least bit surprised to find the fiscal 1984 deficit of roughly $60 billion less than the current CBO official projection.

Again, I am going to toot the horn of the chamber on this. Our forecasting record has been far better over the last few years on interest rates, on deficits, on economic growth, than has been CBOI or the administration for that matter.

Mr. JONES. So, essentially what you are saying is that with the path we are following, and if we can stay on that recovery path, we are going to do more to reduce deficits than we would by the possibility of raising taxes and taking a chance on aborting any or all of that recovery. Is that correct?

Mr. RAHN. That is correct. Every time the Congress has passed a major tax increase, you have slowed down economic growth or brought us negative economic growth. Every time we have had major tax reductions—if you go back for 70 years, you found much higher rates of economic growth. There has been, again I will restate, no case, not only in this country but any other industrialized nation, of where major tax increases ever brought forth a balanced budget.

Mr. JONES. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman ROSTENKOWSKI. Are there any further questions? Mr Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Rahn, I would like to ask your thoughts about a spending freeze on all spending including defense spending. Essentially the pay-as-you-go budget theory—that if we lock everything down and require Congress and the President to develop revenue sources at the same time they are asking for an increase in budget for defense or for food stamps or for whatever. Do you generally support that? Would the chamber generally support that?

Mr. RAHN. Yes. We had, in fact, supported the notion of a freeze on spending. We did carve out defense. We had a lesser number than the President, and none of us like to spend any money at all on defense. But unfortunately in the real world we do face a major threat from the Soviet Union, and I think it has been quite clear that we were falling behind in the arms race, and that sometimes in order to protect our essential liberties, and the future for economic growth, we had to spend more on defense than probably any of us would like. But other than that, a spending freeze we had supported.

Mr. CAMPBELL. But generally do you support increasing revenues or increasing taxes in order to pay for that increase in defense spending that you support?

Mr. RAHN. If you have even a modified spending freeze, in fact we had worked with several Members of the Congress, both in the House and the Senate, working on even a modified spending freeze, not a total spending freeze, without any major tax increases, you have reached a balanced budget assuming reasonable rates of economic growth like we have had in previous recoveries, in 1988 or 1989.

Mr. CAMPBELL. I don't understand the answer. The answer is no?

Mr. RAHN. I am saying without increasing taxes and even with a modified spending freeze, not a hard spending freeze, including the 7-percent increase in real defense expenditures, you would reach a balanced budget no later than 1989.

Mr. CAMPBELL. I appreciate your answer. Let me make a couple of points here. One, I have studied and also taught economics. You mentioned you didn't want to toot your own horn but you tooted it just a little bit being slightly closer to the numbers than CBO or some others in the early part of the administration, the new administration program.

The fact is I don't know of any economist or group of economists or organizations who employ economists, including the chamber, that even hit the right wall, let alone the target. I mean, I don't think anybody predicted the second recession that hit us. People were predicting growth, and, in fact, we didn't have growth.

We moved into a recession that was deep and long, the deepest and longest in four or five decades. Consequently I have always felt that we ought to have a truth-in-forecasting requirement, that when economists come before committees, and since I have an economics background I would include myself in that requirement, we ask them what were your forecasts 5 years ago, 4 years ago, 3 years ago.

We should ask what was the performance and analyze what kind of forecaster one is, not just from the chamber but from virtually every area from where we receive forecasts, because we really had difficulty in that area.

I make one other observation. Mr. Jones is talking about ACRS and capital gains and so on. The fact is one of the problems that we have is that you can achieve the benefits of ACRS and ITC and other provisions in the Tax Code without producing anything, without producing one job, without producing one new board, without growing one plant.

You don't have to do anything in order to achieve the benefits of ACRS except produce some paper between some attorneys and some accountants. That is precisely the problem in our economy today, paper entrepreneurialism that achieves the rewards of the kinds of things we put in the Tax Code but does not create one blessed job.

If we can pare away these nonproductive kinds of incentives in the Tax Code and really focus the incentives on the activities that are creating jobs and giving the businesses, entrepreneurs in business who want to expand, the opportunity to expand, then we will have done something for this country, in my opinion.

Let me conclude by asking a question. When the President came to town, he said, "I am going to propose a series of budgets," his first, and also some projections beyond the first. He said in the first budget, "By 1984 I am going to achieve a balanced budget. I am going to ask for $770 billion in spending in 1984 and I am going to estimate that we will receive $770 billion in revenue."

The year 1984 is here. Fiscal year 1984 is the budget we are now working on. The President did not ask for $770 billion in spending. He asked for $850 billion in spending. But more important than that, the President did not anticipate $770 billion in revenue in 1984. He anticipated $660 billion in revenue. In other words, $110 billion in revenue that he expected a couple of years to be there in his estimates for fiscal year 1984 that is not there now.

Therefore, for that reason and other reasons, we have an estimated $200 billion Federal budget deficit. You say let's not increase taxes, let's substitute spending. Precisely, then, where would you cut spending in order to resolve this problem?

Mr. Rahn. As far as cutting spending, basically we just have to restrain the growth in spending, and the way you can do that is if you take all the various discretionary programs you have now, and hold them at an absolute level, not cutting them, just holding them constant, and then having, let's say, a 1-year freeze on your various cost-of-living adjustments, and after that, there is a number of formulas you can use—I will give you an example of one:

Sixty percent of the CPI—as a former professor of economics you know as well as I do the CPI has tended to overstate the real rate of inflation for most Americans, and if you used a formula like 60 percent, which is roughly equivalent to the average of private sector COLA adjustments, you would again by 1989 bring them into balance.

Mr. Campbell. I understand that, but the point is that what you are saying in summary is let's do nothing for the moment, except freeze future increases, or at least moderate the rate of future increases or forestall future increases. What that answer says is let's do nothing for the moment. There are some who feel, myself included, that doing nothing at a time when we have an economy that is coming out of a recession. The economy hopefully will gain some strength and therefore will have additional private-sector credit needs. Having a $200 billion Federal deficit at that time inevitably will result in crowding out and inevitably will lead to increased interest rates, and those increased interest rates will lead to an economic nosedive.

Mr. Rahn. My problem is that the solutions being proposed are worse than doing nothing, and I guess I look at doing nothing as the best political alternative we have now. But many of the tax increases that have been proposed are clearly tax increases on savings investment that will slow down economic growth, will do nothing to reduce the amount of crowding out, and just make more economic misery and higher rates of unemployment, and that is not what any of us want.

Mr. **Campbell.** If I may indulge the Chair for one more moment. I understand your point that tax increases improperly applied as the country comes out of a recession could very well be detrimental to an economy that is gaining strength; but all you have to do is look at this punchboard of gimmicks we call the Tax Code, and the application of that Tax Code to various economic activities in the country. I think you will understand that there are areas, there are sectors of our economy, that are not paying their way, for various reasons.

Why on Earth would it be detrimental to our economy, or to our deficit reduction program, to selectively and with good judgment go in and get that revenue that we should now be getting, without jeopardizing job creation? You are suggesting that any new taxes somehow threatens job creation or threatens economic recovery. Aren't there areas of new tax collections that we can achieve without threatening recovery?

Mr. **Rahn.** I will get to that, but I know my colleague Dr. Albertine would also like to respond.

Mr. **Albertine.** We would love to send you our Hatsopoulos study which looks at the relative cost of capital in the United States versus Japan. I think if you look at those numbers—and again we have had most of the spectrum of economists look at it, and they don't disagree except perhaps at the margin with the numbers—the fact of the matter is we are not competitive with respect to the cost of capital that exists now with our current tax code. If you raise effective corporate rates, you make the situation worse.

We think that unless we seriously undertake a long-term program to cut the cost of capital radically, this country is in fact going to be what you suggest it might be, which is a bunch of industries shuffling paper and not productive in the basic industries or even in the high-tech industries.

Mr. **Campbell.** I would very much like to see that study. There are other studies——

Mr. **Downey.** Are there other members of the panel that desire to question? The gentleman from Texas.

Mr. **Hance.** Dr. Rahn, in your testimony you mentioned the need for spending cuts, and Mr. Koplan, in your testimony you don't mention spending cuts at all. I have a question for all four of you. I don't know if you are familiar with the Danforth-Boren proposal reducing automatic COLA's for nonmeans tested entitlement and tax indexing to 3 percentage points below the CPI. In other words, CPI measures inflation at 6 percent, COLA's would be limited to 3 percent. And on the tax indexing that goes into effect in 1985, the same thing would apply.

I would like for all four of you just briefly to tell me if you all would consider supporting something like this, that addresses spending as well as revenue increases.

Mr. **Huard.** Yes, Mr. Hance. We would give very serious consideration to supporting that approach. We have been saying for some time mostly in commenting on proposals to repeal indexation of tax rates that that would be a cardinal mistake, the indexing of tax rates. It should not be modified or adjusted unless and unless there is a comparable modification or adjustment on the expenditure side to control indexed entitlement programs, which basically, if they are not controlled, there is never going to be any solution to the deficit problem that we have.

Mr. **Albertine**. Mr. Hance, we would be very cautious with respect to that proposal, because it treats the two sides of the ledger as if they are the same thing. Indexation of proposals, indexation of programs, which provide moneys to people from other people, are not the same thing as indexation of taxes for those people who are pulling the wagon.

They are not comparable programs, spending and tax programs. Our view is that the critical question with respect to the long term in this economy is the cost of capital, and that is partially dependent on the proportion of resources which go to the public sector. Our own view is that we would prefer to look at the spending side, make the adjustments on the spending side, and allow people who are engaged in productive activity to keep as much as possible of the revenue that they earn.

Mr. **Hance**. Dr. Rahn.

Mr. **Rahn**. I totally concur with Dr. Albertine's comments on that. Also the notion of just 3 percent, even if you went that way, would not be as good as using a percentage of the whole amount, because the 3 percent has far less positive impact to high rates of inflation than lower rates of inflation, but again the spending and taxing issues are totally separate.

Mr. **Hance**. Would you advocate, then freezing both for, say, 2 years or 3 years?

Mr. **Rahn**. I would not be for a freeze on the tax changes you have already enacted, talking about tax reduction, for the reasons that I listed in my testimony.

Mr. **Campbell**. Would the gentleman from Texas yield?

Mr. **Hance**. I yield.

Mr. **Campbell**. I thank the gentleman.

This 3-percent proposal that Danforth and others put in, I actually drafted back in about January of this year and sent it over to the Senate. The reason there is a 3-percent provision and nothing else is because the 3-percent trigger is what is in law now on all of your guaranteed index programs. As you know, if inflation or CPI is under 3 percent, there is zero, and it is 100 percent over three. Since current law contains a trigger, it was chosen as a method for indexing personal income taxes.

Before you comment on that, the other side of the coin, I realize as a conservative who has supported a lot of the President's programs, is that there is a keen difference between the tax side and the spending side.

I also realize that we have not seen the spending cuts that were asked for in relation to the overall program that were necessary. That has exacerbated the deficit problems, and to deal in this manner was to deal strictly with a quid pro quo that was rather simple on the three and three. That is the reason it got to the point that it did, and I thank the gentleman from Texas for yielding.

Mr. Rahn. On the spending side alone, if I had a vote I would clearly vote for that, if that is what we could get, because it would be a great improvement over what we now have.

Mr. Albertine. Mr. Hance, let me interrupt to say I answered your question as the president of the American Business Conference, and not as the chairman of the Coalition to Reduce High Effective Tax Rates. That coalition hasn't taken a position on that issue.

Mr. Hance. Mr. Koplan.

Mr. Koplan. Thank you. We come down just the opposite from the other members of this panel. Rather than changing the indexing of programs such as food stamps, social security, Government retirement, what we have tried to do today is to offer a list to choose from of tax reforms that would more than meet the requirements of the budget, which we supported. We think that is the way to go. We feel that going into programs in the fashion that——

Mr. Hance. You all would be against any cuts in——

Mr. Koplan. Yes, because that would impact primarily, again, on the lower and middle-income people.

Mr. Hance. Last year we raised the gasoline tax and the heavy vehicle use tax on the trucking industry. As a result all the trucking industry people are going to have to increase their rates, absorb part of the increase, or just go out of business. But ultimately, the consumer is going to come back and pay for those tax increases.

I think one of the real problems that we see from this panel, that the members see, is that one side says they don't want any cuts in spending and the other side says they don't want any increases in taxes.

I agree with Dr. Rahn on one thing: You are never going to balance the budget by increasing taxes. The problem we get into, politically speaking, is when we try to just increase taxes. At some point in time, some compromise is going to have to be worked out on spending and taxes or we will never address the problem.

Mr. Cantor. Mr. Hance, if I may, just on that point. I think you really have to consider the context of why these hearings are being held now. It is not a question of starting from scratch and using the arguments whether we should increase or decrease taxes in the abstract.

The fact is that as a result of going far too far in 1981, taxes were cut far too much, and we are here trying to patch up the damage. So it is not an abstract argument here. We have got to patch that damage and make up for those excesses in the most fair and equitable fashion.

Mr. Hance. Of course, I would answer that by saying that no one has ever stopped me and said that the problem is that their taxes were lowered too much in 1981. I don't think the American public sees it that way. I would like to ask your comments on one other possibility. What if we passed a tax bill and put a trigger mechanism in so that if there weren't certain spending cuts that went into effect, the tax in the future wouldn't go into effect?

Mr. Cantor. I think we have gone far enough on the spending side in terms of cutting, and we have gone much too far on the tax side.

Mr. HANCE. Yes or no from the other three.

Mr. HUARD. I would be inclined to give that some favorable consideration. I don't disagree with the comments Dr. Rahn and Dr. Albertine made on the difference between taxing income and making Government expenditures. The reason I said I would support the type of trade-off of the Boren bill is basically because of the political facts of life. You are not going to get reduction in entitlement programs unless you trade off reductions in individual tax rates.

Mr. HANCE. What about the trigger mechanism; if the tax bill passes, would you all be in favor of at least some type of trigger mechanism that would prevent the increases from going into effect unless there were some type of spending cuts?

Mr. ALBERTINE. That is preferable to just a tax increase, Mr. Hance. I go back to the point which was made earlier with respect to econometricians' ability to predict the future. I don't know anybody who can tell me what is going to go on in this economy in 1984, 1985, or 1986, and I think the trigger mechanism has the problem of perhaps——

Mr. HANCE. What would happen at that time. Dr. Rahn.

Mr. RAHN. I guess I would like to go back to TEFRA because we were promised we would get $3 spending growth reduction for each dollar of tax increase. Instead we got 29 cents in spending growth increase for each dollar of tax increase. If you retroactively applied the trigger, I would be in favor of it.

Mr. HANCE. Thank you very much.

Mr. DOWNEY. Are there other members of the panel?

Mr. PEASE. Mr. Chairman, just quickly, I would like to make just one observation and ask one question. There was some discussion earlier between the gentleman from Oklahoma, Mr. Jones, and the representatives from the AFL-CIO about the reduction in the capital gains rate.

I heard the argument being made by my colleague that there is no revenue loss—if you reduce the capital gains rate you don't produce less revenue. You produce more revenue and that may or may not be true. I think there was some discussion about that. But I would like to enter into a discussion in another dimension which ought to be taken into account, and that is the equity of it.

Right now we are talking about a maximum capital gains rate of 20 percent, and a lot of ordinary working Americans who are out slogging away every day working on the assembly line or whatever are paying a higher marginal tax rate than 20 percent.

I think there is some question about the fairness of that, irrespective of whether reducing the capital gains rate might produce as much revenue. Otherwise I would just like to ask Mr. Rahn, since he has expressed such great confidence in the forecasting ability of the Chamber of Commerce as compared with CBO and others, if he could provide to me forecasts made by the Chamber of Commerce in 1981, for fiscal years 1982, 1983, and 1984, for all the relevant things, GNP growth rate, inflation, unemployment, Federal spending, Federal revenue, deficits, and so on. Could you do that?

Mr. RAHN. We would be happy to supply you with a whole series of comparable economic forecasts of ours and a lot of other groups.

Mr. Dorgan was absolutely right. Economists have much to be modest about, and my argument is we have been less wrong in the majority of particulary Government forecasters.

Mr. **Pease**. Fine. If you could provide me with that narrow information that I asked for in a package, then you can give me anything else that you want. I would be happy to have it.

Mr. **Rahn**. Fine.

Mr. **Pease**. Thank you.

Mr. **Downey**. Mr. Vander Jagt.

Mr. **Vander Jagt**. Thank you, Mr. Chairman.

I don't have any questions. While I didn't have the opportunity to hear the testimony, I did read it, and I would like to thank and commend the members of our panel for their contribution this morning. Thank you.

Mr. **Downey**. May I ask just one question for Mr. Albertine. Do you agree or disagree with this statement "Government spending that is financed by deficits is primarily the expense of private investment, while Government spending that is financed by general taxes on income or spending is primarily at the expense of private consumption"?

Mr. **Albertine**. No, I would not agree with that, Mr. Chairman. I think that in general terms spending financed by borrowing is probably skewed in the direction of being financed by reductions in investment. Tax increases are probably generally skewed in the direction of reductions in consumption, and I think it does matter a great deal how you do in fact raise taxes.

Mr. **Downey**. Quoting from Mr. Feldstein's——

Mr. **Albertine**. He is generally close to being correct.

Mr. **Downey**. Other members of the panel? Mr. Campbell.

Mr. **Campbell**. Mr. Chairman, just one observation. We were discussing the 3-percent item a while ago. When we first started on that proposal and working on it, it was made very clear, and I would like to make clear again, that no way would I, or that I know of any of the others that have worked in this direction, be interested in any manner in having a 3-percent trigger on tax indexing without the 3-percent offset on all other indexing.

It is not an acceptable item in any proposal that has been made, and the reason it is not is because, as was reemphasized by Dr. Rahn, the fact that the spending reductions of the past did not take place, and so it would have to be all as one.

Mr. **Downey**. Thank you.

The Chair thanks the members of the panel.

We will next hear from John Fitch, vice president of government relations of the National Association of Wholesaler-Distributors; Robert McIntyre, director of the Federal tax policy for Citizens for Tax Justice; John Motley, deputy director of Federal legislation for the National Federation of Independent Business; and Wilfred Tremblay, chairman-vice president for taxes, Hanna Mining Co., for the Tax Council, in that order.

Mr. Fitch, you are familiar with the ground rules here in the committee. We would be delighted to hear your statement for 5 minutes. Thank you, Mr. Motley and Mr. Tremblay, Mr. McIntyre.

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT FOR GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. FITCH. Thank you, Mr. Chairman. I request my statement be submitted for the record in its entirety. I will just summarize them briefly as you suggest.

On behalf of the National Association of Wholesaler-Distributors, NAW's 120 member national associations and their 45,000 wholesaler-distributor firms and as a member of the Coalition to Reduce High Effective Tax Rates, NAW strongly opposes any tax increases in fiscal years 1984, 1985, or 1986 as a means to reduce the Federal deficit.

NAW believes that the root cause of the Federal deficits the Nation is experiencing is excessive Federal spending. Until this spending is brought under control there is little hope for reducing the Federal deficit.

I would just like to emphasize at this point the statement of Dr. Rahn and Dr. Albertine about the lack of spending reductions that were promised in 1982 under the budget resolution, when we received the $100 billion tax increase, an unacceptable trade-off in our view.

Moreover, we believe raising taxes at this time will exacerbate the current economic problems of business and threaten the recovery.

Given the lack of significant reductions in Federal spending contained in the first concurrent budget resolution for fiscal year 1984, tax increases will only take productive investment capital from the private sector consequently increasing the Federal Government's share of the capital stock; raising interest rates; eroding profits and cash flow; and, further increasing a wholesaler-distributor's dependence upon borrowed capital to fund operations, growth, and job creation rather than using retained earnings.

All this to fund Federal spending; not to reduce the deficit.

Specifically, NAW is opposed to the following tax increases:

First, corporate surtax. As my statement points out, the average wholesaler-distributor has a 32-percent effective tax rate. A surtax would only increase his tax liability while leaving others untouched. It is neither broad based nor equitable. In this regard, Mr. Chairman, NAW strongly supports the position stressed earlier by Dr. Albertine on behalf of the Coalition To Reduce High Effective Tax Rates.

Second, a freeze on the following tax reductions enacted as part of the 1981 Economic Recovery Tax Act but which have not yet been phased in: No. 1, estate tax reductions. These are extremely important to small, closely held, family-owned businesses such as wholesaler-distributors.

No. 2, direct expensing. No. 3, value of used machinery subject to the investment tax credit. No. 4, indexing the individual tax brackets.

Third, increasing the number of years over which structures can be depreciated under the accelerated cost recovery system. Warehouse and structures are the main capital asset of wholesaler-distributors. Their depreciable life was considerably reduced under

ACRS from 60 years to 15 years, and the consequent recovery of investment to wholesaler-distributors has been substantial. This has allowed them to modernize their warehouses, to build new warehouses, to increase jobs, and to better compete in the national and international marketplace.

Mr. Chairman, I appreciate the opportunity to represent and present the views of the wholesale-distribution industry here this morning. I will be happy to answer any questions.

Thank you.

[The statement of Mr. Fitch follows:]

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT-GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

SUMMARY

Mr. Chairman, on behalf of NAW's 120 member national associations and their 45,000 wholesaler-distributor firms and as a member of the Coalition To Reduce High Effective Tax Rates, NAW strongly opposes any tax increases in FY 1984, 1985 or 1986 as a means to reduce the federal deficit.

NAW believes that the root cause of the federal deficits the nation is experiencing is excessive federal spending. Until this spending is brought under control there is little hope for reducing the federal deficit.

Moreover, raising taxes at this time will exacerbate the current economic problems of business and threaten the recovery.

Given the lack of significant reductions in federal spending contained in the First Concurrent Budget Resolution, tax increases will only take productive investment capital from the private sector consequently increasing the federal government's share of the capital stock; raising interest rates; eroding profits and cash flow; and, further increasing a wholesaler-distributor dependence upon borrowed capital to fund operations, growth, and job creation rather than using retained earnings.

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Specifically, NAW is opposed to the following tax increases:

(1) Corporate Surtax

(2) A "Freeze" on the following tax reductions enacted as part of the 1981 Economic Recovery Tax Act but which have not yet been phased-in:

- o Estate tax reductions
- o Direct expensing
- o Value of used machinery subject to the investment tax credit
- o Indexing the individual tax brackets

(3) Increasing the number of years over which structures can be depreciated under the Accelerated Cost Recovery System.

FULL STATEMENT

Mr. Chairman, Members of the Committee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

NAW is a founding member of the Coalition To Reduce High Effective Tax Rates; a group of corporations and associations representing those firms in the manufacturing, wholesale distribution, and retail segments of the economy who have high effective tax rates.

The objectives of the Coalition were presented earlier to the Committee by Dr. John M. Albertine, Chairman of the Coalition along with the Coalition's specific views strongly opposing a corporate surtax and other potential tax increases in FY 1984.

NAW wishes to underscore that position and associates itself with the views expressed by the Coalition.

NAW

The National Association of Wholesaler-Distributors is a federation of 120 national wholesale distribution associations[1] which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business.

The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

The Industry

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely held, family-owned businesses. Of the

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[1] Appendix A.

238,000 merchant wholesaler-distributor corporations in the United States, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. Average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy2/.

Industry sales totaled approximately $1.2 trillion in 1982 and are expected to reach over $1.4 trillion in 1983, according to United States Commerce Department estimates.

A 1982 profile of the wholesale trade, as compiled by the U. S. Department of Commerce from Census Bureau figures, shows the following:

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[2] Appendix B

SIC CODES: 50-51

Sales (million $)	1,163,400
Employment (000)	5,290
Number of establishments	307,264
Compound annual rate of growth, 1972-82:	
Sales (percent)	12.6
Employment (percent)	2.5
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

TAXATION AND THE WHOLESALE DISTRIBUTION INDUSTRY

General

Wholesale distribution is labor intensive. On average, a wholesaler-distributor employes 40 to 50 people. Thus, employment (payroll) taxes are of extreme concern because of their direct and immediate consequences on cash flow.

For example, currently the average wholesaler-distributor is paying $43,000 annually in Social Security taxes alone. This represents 43 percent of the average after-tax earnings for such a wholesaler-distributor. The scheduled increases contained in the recently enacted Social Security Reform Act of 1983 will raise that 43,000 figure to $64,000 by 1990; a 53% increase in only seven years!

Add to that the FUTA tax increases contained in the Tax Equity and Fiscal Responsibility Act of 1982 and the "top-heavy" pension provisions also contained in TEFRA and one begins to see the dramatic impact employment taxes have not only on cash flow, but, also, on job creation. The small wholesaler-distributor cannot absorb these direct costs as can larger firms. He must, therefore, reduce the number of employees just to stay even. This also has a consequent effect on the wholesaler-distributor's ability to compete in the marketplace.

Eighty-percent (80%) of a wholesaler-distributor's assets consist of inventory and accounts receivable. The remaining twenty percent (20%) represents investment in real estate, structures (warehouses) and to some extent, machinery and equipment.

Therefore, the cost of money (interest rates) to finance the inventory and receivables is critical; as is the wholesaler-distributor's ability to recover quickly the cost of investment in capital assets.

Tax policy that allows for rapid recovery of capital investments; increases cash flow by reducing the cost of labor; and allows for low-cost financing of warehouse construction and moderization is the key to a wholesaler-distributor's economic well-being. Such policies increase retained earnings and decrease dependency on outside sources of financing (traditionally commercial bank loans). The result is economic growth and expansion, job creation and a healthy and competitive economic environment in which to prosper.

To the extent that the tax burden in any one or all of these areas is increased, the ability of a wholesaler-distributor to grow or even maintain itself is severly hindered.

Finally, tax policy that encourages entrepreuneurs to remain independent by passing their businesses from generation to generation is important to the family-owned wholesaler-distributor. Such a policy fosters not only stability within a single company but also within the community in which that business is located and the industry to which it belongs. Moreover, it insures the perpetuation of the competitive environment which stimulates innovation, creativity, job creation and which gives the free-enterprise system its vitality.

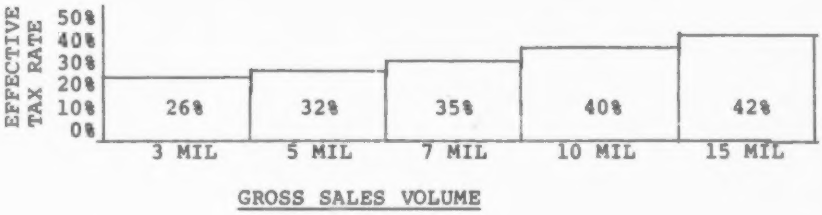
The following is an example of the average wholesaler-distributor from a tax standpoint. The calculations are estimates only and are based on the IRS Statistics of Income:

TYPICAL WHOLESALER-DISTRIBUTOR

Average Gross Sales	4.5 millions
Average Taxable Income	161,000
Average Tax Liability	50,000
Average Depreciation	30,000
Average Investment Tax Credit	5,000
Average Effective Tax Rate	32%

Since investment patterns generally do not vary with size in the wholesale-distribution industry, the chart below graphically illustrates the impact of increased effective tax rates when viewed against annual gross sales:

EFFECTIVE TAX RATES
AS A FUNCTION OF GROSS SALES VOLUME
FOR WHOLESALE-DISTRIBUTION INDUSTRY



FEDERAL DEFICIT AND PUBLIC POLICY

During the past 25 years, there has been a balanced-budget only four times.

In our judgment, there are only two ways to end federal deficit spending: either increase taxes or decrease spending. NAW believes that the federal government already consumes too large a portion of the gross national product. Every dollar taken from a wage-earner or a business for government spending is one dollar less that individual or business can spend in a manner that would bring the greatest benefit to that taxpayer. No amount of government spending can achieve prosperity; additional government spending can only lead to increased inflation and exacerbate the "crowding-out" problem.

NAW strongly supports Administration and Congressional efforts to reduce federal spending in all areas but particularly in the entitlement programs. These programs consume the greatest amount of federal revenues, and yet ironically, are not subject to annual congressional scrunity.

Increasing taxes does not solve the deficit problem but rather exacerbates it; particularly for those companies who pay taxes at high effective rates. Tax increases take investment capital from the private sector which increases the "crowding-out" problem, raises interest rates, erodes profits and cash flow, and further increases a wholesaler-distributors dependence upon borrowed funds for operations, growth, and expansion.

NAW has been consistent on this point.

In 1981, we strongly supported the Administration's entire economic recovery program.

In 1982, NAW supported the budget resolution on the premise that for every dollar in tax increase there would be a corresponding three dollar decrease in federal spending.

However, when it was clear that the spending decreases were not to be realized (and still have not) the NAW Board of Directors voted unanimously to oppose TEFRA.

In 1983, NAW opposed the payroll tax increase to finance Social Security and opposes the First Concurrent Budget Resolution for FY '84 because it fails to deal with the root cause of the deficit: uncontrolled federal spending, and instead tries to solve the problem by raising taxes another $73 billion.

As businessmen and women, wholesaler-distributors over the last two years have had to deal with the harsh reality of a severe recession and depressed sales. The only way they have survived (and many did not) was to cut their costs to meet reduced revenues.

They find it incredulous that in the face of the recent recession and in light of the current recovery, Congress wants to increase federal spending and raise taxes to pay for it rather than cut costs to meet revenues. An irresponsible action in the minds of our members.

Wholesaler-distributors are beginning to lose confidence in their elected officials' ability to enact responsible and rational public policy to deal with the economic problems of this country.

TAX INCREASE OPTIONS OPPOSED BY NAW

As a matter of policy, NAW strongly opposes any tax increases in FY 1984, 1985 or 1986; particularly without significant corresponding reductions in federal spending (including the entitlement programs).

Specifically, as an industry, NAW opposes the following tax options currently before the Committee for consideration:

(1) Corporate Surtax

As indicated earlier, wholesaler-distributors have high effective tax rates. A surtax would fall heaviest and disproportionally on wholesaler-distributors and other high tax payers. Therefore, it is neither broad based nor equitable and penalizes those who pay taxes and leaves untouched those who do not.

On this issue, NAW strongly supports and associates itself with the testimony presented earlier to the Committee by the Coalition To Reduce High Effective Tax Rates.

(2) "Freeze" on all non-phased-in portions of the Economic Recovery Tax Act of 1981

To freeze all non-phased-in provisions of the Economic Recovery Tax Act of 1981 would not only increase a wholesaler-distributor's frustration at the lack of certainty in tax planning, but, also, that action would fall almost exclusively on small, family-owned businesses and individuals.

Therefore, NAW specifically opposes a "freeze" on or repeal of:

- 1981 estate tax reductions;
- The value of used machinery subject to the investment tax credit;
- Direct expensing;
- Indexing the individual tax brackets.

If I might point out Mr. Chairman, H.R. 4242, this Committee's 1981 tax reduction bill, also included identical estate tax reductions and direct expensing provisions.

(3) Extending the depreciable life of structures

As indicated by the chart below, the enactment of ACRS in 1981 had a dramatic impact on the ability of a wholesaler-distributor to recover his investment in his warehouse (even using component accounting under the old ADL system). Since the warehouse is the main capital asset of a wholesaler-distributor, this provision has tremendous value for a wholesaler-distributor who wishes to modernize an existing warehouse.

Therefore, NAW strongly opposes any revenue option that would increase the number of years over which a structure can be depreciated:

Comparison chart for a $1,000,000 warehouse using
the old ADL system and the current ACR system

	ADL		ACRS	
Year	SL	DDB	SL	%
1	$ 27,027	$ 54,054	$ 66,666	$ 70,000
2	27,027	51,132	66,666	120,000
3	27,027	48,368	66,666	110,000
4	27,027	45,753	66,666	90,000
5	27,027	43,280	66,666	80,000
6	27,027	40,941	66,666	70,000
7	27,027	38,728 (32%)	66,666 (46%)	60,000 (60%)
8	27,027	36,634	66,666	50,000
9	27,027	34,654	66,666	50,000
10	27,027	32,781	66,666	50,000
11	27,027	31,009	66,666	50,000
12	27,027	29,333	66,666	50,000
13	27,027	27,747	66,666	50,000
14	27,027	26,247	66,666	50,000
15	27,027	24,829	66,666	50,000
TOTALS	$405,405 (40%)	$565,490 (56%)	$1,000,000	$1,000,000

An increase in five depreciable years over the current 15 would reduce the capital recovery for a wholesaler-distributor by approximately 30%.

Another substantial bottom-line take away.

I might point out again, Mr. Chairman, that this Committee included a 15-year depreciation life for structures provision in your 1981 tax bill, H.R. 4242.

CONCLUSION

Mr. Chairman, while NAW does not want to appear dogmatic or obstructionist in our position here today, we do feel compelled, on behalf of all the wholesaler-distributors around the country, to express our strong opposition to raising taxes to reduce the federal deficit particularly in light of the impact that would have on the current economic recovery and in light of the lack of any corresponding substantive reduction in federal spending.

In our judgment, until federal spending is significantly reduced and under control, any tax increase will only have a debilitating affect on the economy.

Thank you Mr. Chairman, we appreciate the opportunity to present our views here today.

National Wholesaler-Distributor Organizations
Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Services Association
American Veterinary Distributors Association
Amusement & Vending Machine Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Associated Wire Rope Fabricators
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Coated Abrasives Fabricators Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Health Industry Distributors Association
Hobby Industry Association of America

Independent Medical Distributors Association
Institutional & Service Textile Distributors Association, Inc.
International Ceramic Association
Irrigation Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Spring Service Association
Steel Service Center Institute

Textile Care Allied Trades Association
Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Distributors Association
Warehouse Distributors Association for Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

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1725 K Street, N.W., Washington, D.C. 20006 • 202/872-0885

United States
Wholesale Distribution Industry
Summary Statistics by State[1]

I. National	Establishment (Number)	Sales ($000's)	Average Sales $ Per Establishment	Payroll ($000's)	Employees (Number)
Wholesale Trade	382,837	1,258,400,268	3,287,039	58,289,573	4,397,089
II. State					
Alabama	5,713	14,185,813	2,483,076	705,379	63,548
Alaska	649	1,562,699	2,407,857	115,905	6,232
Arizona	3,587	8,091,848	2,255,882	470,913	39,139
Arkansas	3,665	6,769,264	1,847,002	361,955	34,023
California	36,704	128,628,351	3,504,478	6,334,251	448,808
Colorado	5,457	15,617,678	2,861,953	790,751	60,824
Connecticut	4,694	19,233,684	4,097,504	811,741	59,102
Delaware	770	5,155,611	6,695,599	192,376	12,441
District of Columbia	594	2,154,745	3,627,517	169,063	10,866
Florida	15,409	34,380,491	2,231,195	1,822,284	158,901
Georgia	10,085	35,213,332	3,491,654	1,462,358	118,161
Hawaii	1,569	2,571,489	1,638,935	177,556	14,695
Idaho	2,037	3,194,237	1,568,108	210,537	20,338
Illinois	21,237	97,080,216	4,574,021	4,207,197	280,312
Indiana	8,875	25,439,511	2,866,424	1,223,642	97,402
Iowa	7,646	20,078,789	2,626,051	825,097	68,559
Kansas	5,349	17,460,965	3,264,342	652,573	53,949
Kentucky	5,133	13,485,315	2,627,180	646,720	56,075
Louisiana	6,800	19,568,473	2,877,717	955,683	81,238
Maine	1,580	2,830,910	1,791,715	177,823	16,725
Maryland	5,019	16,900,800	3,367,364	902,244	67,121
Massachusetts	9,107	30,235,785	3,320,060	1,549,866	113,072
Michigan	12,527	45,151,519	3,591,435	2,108,920	141,484
Minnesota	8,625	29,092,203	3,373,009	1,283,969	94,320

(over)

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[1] Compiled by the National Association of Wholesaler-Distributors from 1977 U.S. Census of Wholesale Trade

United States
Wholesale Distribution Industry
Summary Statistics by State[1]

I. National	Establishment (Number)	Sales ($000's)	Average Sales $ Per Establishment	Payroll ($000's)	Employees (Number)
Mississippi	3,592	6,980,068	1,943,225	380,486	36,158
Missouri	10,007	35,080,391	3,511,149	1,519,797	115,784
Montana	1,815	2,968,857	1,635,734	162,348	14,176
Nebraska	4,164	10,648,164	2,557,196	494,245	42,273
Nevada	995	1,747,881	1,756,664	126,617	9,467
New Hampshire	1,223	2,024,293	1,655,186	147,703	12,097
New Jersey	12,997	55,327,312	4,256,929	2,651,785	182,023
New Mexico	1,969	2,714,261	1,378,497	192,127	17,297
New York	38,149	165,380,274	4,335,114	6,115,472	410,502
North Carolina	9,571	27,513,222	2,874,644	1,253,867	107,777
North Dakota	2,126	3,889,871	1,829,667	195,510	16,981
Ohio	16,643	61,702,900	3,707,439	2,927,562	212,354
Oklahoma	5,488	13,420,256	2,445,382	638,877	53,447
Oregon	4,904	18,085,350	3,687,877	765,363	54,312
Pennsylvania	17,536	53,711,351	3,067,995	2,817,940	211,479
Rhode Island	1,480	3,075,704	2,078,178	206,420	16,803
South Carolina	4,112	8,265,612	2,010,120	461,821	41,859
South Dakota	1,897	3,401,448	1,793,067	162,051	15,433
Tennessee	7,406	29,277,435	3,953,205	1,127,124	92,501
Texas	26,370	87,681,954	3,325,065	3,853,446	309,616
Utah	2,301	5,361,938	2,330,264	327,991	26,561
Vermont	746	1,036,523	1,389,441	75,025	7,068
Virginia	6,254	19,088,402	3,052,191	955,166	79,315
Washington	7,091	19,852,195	2,799,633	1,084,836	76,615
West Virginia	2,372	4,492,662	1,894,040	299,671	25,317
Wisconsin	7,874	19,648,057	2,495,308	1,111,980	86,408
Wyoming	879	1,940,161	2,207,237	75,540	6,131

For further information on the wholesale distribution industry and the National Association of Wholesaler-Distributors, write: NAW, 1725 K Street, N.W., Washington, D.C. 20006; or call: 202/872-0885.

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Mr. **Downey**. Thank you.
Mr. McIntyre.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

Mr. **McIntyre**. Thank you, Mr. Chairman.

My name is Robert McIntyre. I am here representing Citizens for Tax Justice. We are a coalition of labor, public interest, and citizens groups, and through our member organizations we represent tens of millions of middle and lower income Americans.

Many of our constituents, I am sorry to tell you, are quite angry at the Government, and quite angry at the Federal tax system in particular. If you go back about 5 years and compare, you will see that taxes on the bottom half of the population have gone up by about half. Taxes on the next third of the population have gone up by about 15 percent. Of course Federal revenues haven't gone up, because taxes on the highest income group have been cut over the last few years by more than a third, and the corporate income tax seems to have all but disappeared.

In the first 8 months of this fiscal year, 4.5 percent of Federal revenues were provided by the corporate income tax—corporate payments covered only 3.1 percent of spending. Many of us aren't old enough to remember a time when corporate taxes were as low as they are today in constant, absolute dollars. In fact you have to go back to before Pearl Harbor. If you look at particular industries you find, as Congressman Dorgan and Congressman Pease found in their studies, that chemical companies pay 5 percent, commercial banks 2 percent, crude oil producers 3 percent, railroads nothing at all. The list goes on and on.

And look at particular companies. General Electric in the last 2 years has made $3.5 billion. It received Federal tax refunds totaling $250 million. The tax system is a terrible mess. It has become very unfair. We think that the budget resolution directed this committee to try to raise some money to solve the deficit problem can be an opportunity to bring back some fairness to the Tax Code and to solve some of the terrible economic distortions that the Tax Code now produces.

One can go down the list of special tax breaks, without being partisan, without being pro one side or the other, and find items now in the Tax Code that are absolutely indefensible and that no one really thinks make any sense. We can easily find enough money to meet the budget targets by taking that route.

Now let me discuss very briefly some of the specific suggestions we have in our testimony, First of all, we think that the chairman's freeze proposal has a great deal of merit. Many of the items on the chairman's list were added during the heat of the 1981 bidding war and are very hard to defend. Obviously the indexing provision is going to be very controversial among the members of the committee. Whatever you do on that, it does not mean you should ignore the rest of the items on the chairman's freeze list.

Second, we have seen, as a result of the 1981 Tax Act, a growth in tax shelters that is absolutely phenomenal. Real estate shelters have been almost doubling every year since 1980, according to the

Wall Street Journal. That is largely due to the fast writeoffs for structures coupled with the lack of recapture in most cases. We suggest lengthening the writeoff period for structures to 20 years and toughening the recapture rules, because it doesn't make any sense for us to have a system that is encouraging people to buy 45,000 used billboards or to trade in used office buildings, as is going on in most of our major cities right now.

The recapture change that we suggest would not hurt legitimate businesses that actually hold on to their property but it would cut back on tax shelters substantially and perhaps divert some capital back into productive activities.

There are a number of other tax shelter reform proposals we have in our testimony, some of which the Treasury has put forward on the Senate side having to do with partnership rules, timing rules, and a number of other areas, and we hope that you will take a hard look at them.

On the depreciation side, we also suggest, as have others, that you eliminate the double dipping on the investment tax credit, a problem that was half corrected in 1982. In other words, we recommend full basis adjustment for the credit and we believe it should be applicable not just to the regular investment credit but to the other credits as well, such as the rehabilitation credit and the R&D credit.

We have several suggestions in the foreign area that we think could also be economically productive. There are a number of provisions in the Tax Code that can pay companies to move abroad. This is not sensible. Does a move abroad make sense from a marketplace viewpoint? Well, then perhaps it has to happen. But it doesn't make sense for us to give tax breaks that encourage moves offshore. Yet we have seen that happen in areas where we have given extra tax credits to companies that manufacture abroad, we have seen it in cases where we give tax breaks to companies that do R&D here and never recapture those breaks when the fruits of that research are shipped abroad, and we see it in cases of companies moving to tax haven countries, and reimporting their products, and tending on their books to allocate most of the profits abroad.

Those problems can be solved, and we have some suggestions on how to do so in our testimony.

Also, there are a number of proposals now before the committee to solve particular problems, such as sale leasebacks, the mushrooming growth of industrial revenue bonds, the life insurance mess, the items covered by the simplification proposal of Mr. Conable and Mr. Rostenkowski, and so forth. We think those are all good ideas, good on their own. They happen to raise some money, too.

So let me just summarize briefly. There are more good ideas and more things that need to be done in the Tax Code than the committee will get to this year, more than we can discuss in 5 minutes. But all of them make sense on their own merits. They also happen to raise money, help cut deficits, and reduce interest rates and help divert capital back to where it does its best job and away from tax shelters.

We hope that is the route the committee takes this year and that is our message.

[The statement of Mr. McIntyre follows:]

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

This Committee has been charged by the Congress with a difficult and painful responsibility. You have been asked to find ways to add $73 billion to federal revenues over the next three years. Those revenues are to be used to reduce the enormous long-term budget deficits that threaten to push up interest rates and abort the economic recovery.

When this Committee held hearings two years ago on the President's 1981 tax program, the overwhelming majority of those testifying supported the administration's policies and promised rosy results if they were enacted. The U.S. Chamber of Commerce's ebullience, for example, was typical. The Chamber's representative told the Committee that "[a]doption of the administration's tax proposals . . . will lead to rapid, sustained economic growth." He said the plan would "promote higher levels of investment, employment, and output by all types and sizes of business," and would "encourage personal savings." "With the administration's program in place," he concluded, "there will be an improvement in the economy, a drop in unemployment . . . and a rise in productivity, real GNP, and workers' pay." And all these wonderful things were to take place almost immediately.

Sadly, as we all know, what actually happened was quite different.

Despite virtual repeal of the corporate income tax, business investment, which was supposed to lead the economy to new heights, began dropping as soon as the program was enacted. It had fallen by 7 percent in real terms one year after the tax bill was passed, continued to fall in the second half of 1982, and is expected to be down in 1983 as well. The two-years-in-a-row decline is a first in the postwar era.

Despite rate reductions for the well-off and billions of dollars in added "savings incentives," personal saving failed to increase. In fact, because of the huge federal deficits, the gross savings in the economy have been increasingly diverted to satisfy federal borrowing needs. In 1982, the amount of savings available for private investment fell to its lowest level as a share of the GNP since World War II—a record we may well break this year.

Unemployment increased by almost half, and today remains 35 percent higher than when the 1981 tax act was signed by the President.

The gross national product fell, productivity failed to increase, and workers' pay, even for those still employed, continued to lag behind inflation.

Small business failures reached their highest rate since the Great Depression.

These cold statistics fail to communicate the real human suffering that underlies them. But they do help illustrate that the theory behind the 1981 tax debacle—that a suspension of tax fairness and economic common sense would lead to a surge in economic growth—was mistaken.

Humbled by the overpromising of 1981, we do not intend to try to persuade this Committee that tax policy changes alone will save the economy. But we do believe that a move toward fiscal responsibility will yield substantial positive economic results, and that tax reforms can be structured to improve economic efficiency without increasing burdens on hard-pressed middle- and lower-income American taxpayers.

In this regard, the 1982 tax reform act and its aftermath are heartening. Last year Congress committed itself to a even more ambitious revenue target—$98.5 billion over three years—and succeeded in achieving that goal mainly by narrowing loopholes and cracking down on tax cheats. The positive fiscal effects were quickly felt.

With future deficits at least somewhat reduced, the Federal Reserve was able to ease up on credit, and short-term interest rates fell substantially. By the fourth quarter of 1982, the inflation-adjusted interest rate on 90-day Treasury bills was down five percentage points from the record high it had reached in the first quarter of that year. Similarly, the real prime rate on short-term business loans declined by 3.6 percentage points. One "leading indicator," the stock market, jumped more than 300 points as measured by the Dow Jones industrial average within a few months after passage of the 1982 tax bill—more that erasing the precipitious fall that swiftly followed enactment of the 1981 tax act. Until recently, the Dow continued to climb, and we now appear to be embarked on a recovery from the depths of the 1981-82 recession.

But the 1982 tax reforms were only a modest beginning toward restoring fairness to the federal tax laws and fiscal responsibility to the federal budget. Deficits still threaten to approach or exceed $200 billion a year for the foreseeable future. Long-term real interest rates have remained at unacceptably high levels—and, in fact, are heading back up right now. This will mean a continued squeeze on housing and consumer durables, continued intolerable levels of unemployment, serious problems in foreign trade, and inadequate business investment.

The challenge now facing this Committee is to continue last year's progress toward restoring the federal tax system's fairness and its ability to raise sufficient revenues to fund the government. In its search for new revenues, Congress should be guided by the pattern of the 1982 tax act.

Tax hikes should be concentrated on those taxpayers who are not paying their fair share. At the same time, tax policy should be directed at removing irrational and unwarranted tax breaks that misallocate capital and labor, impair economic efficiency, and stifle growth.

The distortions that remain in the tax law despite the 1982 reforms present an opportunity to achieve substantial gains in economic efficiency through improvements in the tax code. We cannot afford to miss this opportunity. As the Federal Reserve Board has noted in its 1981 study, *Public Policy and Capital Formation*, "Elimination of the non-neutrality of the tax law may be the best or last hope for raising per capita output and consumption."

Both equity considerations and the need to curb tax-induced distortions dictate that much of the 1983 tax program should be directed at restoring a semblance of order to the taxation of business income. If the failure of the 1981 tax program has any lesson, it is that "trickle-down" corporate tax relief does not guarantee economic prosperity. In the first eight months of the current fiscal year, corporations contributed only $16.8 billion in federal income taxes. This amounts to a mere 4.5 percent of receipts and just 3.1 percent of spending—the lowest share in modern history. In fact, one has to go back to before Pearl Harbor to find a lower level of corporate taxes in constant dollars.

By now it should be clear that taxing corporations is *not* counter to the goals of improving productivity and economic growth. To the contrary, America's heyday of productivity growth (the 1950s and 1960s) was also the heyday of the corporate income tax. The gradual demise of the corporate tax has coincided almost exactly with the drop-off in productivity gains. This is no mere coincidence. The erosion of the corporate tax base has been accomplished by a series of measures that distorted resource allocation and contributed in no small part to our economic problems. It might be noted that Japan, with the world's fastest growth rate, raises a larger share of its government revenues from corporate income taxes than any other industrialized country. And, as with so many other Japanese successes, Japan's tax system, was designed in the early 1950s by Americans.

The list of needed tax reforms is a long one. In 1983, we suggest that the Committee include on its agenda the following areas for action:

1. **Freeze tax cuts enacted in 1981 that are not yet in effect.** We have learned the hard way that the 1981 tax act has produced little except greater tax inequity and larger deficits. The economic miracles that were promised have turned out to be a mirage. The first step in 1983 should be to impose a freeze on the rest of the inequitable tax breaks enacted in 1981—the tax changes that are scheduled to go into effect over the next few years.

Chairman Rostenkowski has introduced a bill to put the remaining portion of the 1981 tax act on ice. One of the items on the Chairman's list, repeal of indexing, is likely to be extremely controversial among the members of this Committee. We have serious misgivings about extension of the 1982-enacted excise taxes. We believe these issues ought to be considered separately and on their own merits. The remainder of the Chairman's freeze program, however, focuses on items added in the heat of the 1981 "bidding war." The list includes:

- The phase-out of the estate tax would be stopped, leaving the exemption from estate taxes at its 1983 level of $275,000 in net worth. (The unlimited marital deduction would still allow all of one's property to be left tax-free to a spouse.)
- The new exclusion for net interest income, scheduled to take effect in 1985, would be repealed.
- The exemption for American working abroad would be frozen at $80,000 (it now is scheduled to go to $95,000 by 1986).
- The "expensing" rule allowing up to $5,000 in equipment investments to be written off immediately, slated to be phased up to $10,000 by 1986, would be frozen at $5,000.
- Further reductions in the oil windfall profit tax that are scheduled to be phased in starting in 1984 would be eliminated.

We strongly support the Chairman's efforts to freeze these items. In fact, in some cases we would go further. The expensing option, for example, was supposed to be an aid to small business. But small businesses are actually better off depreciating their legitimate equipment purchases under ACRS. For a 30-percent-bracket small business, ACRS equipment write-offs and the investment tax credit, even with half-basis adjustment, are the equivalent of expensing 114 percent of the cost of equipment. With full basis adjustment, discussed below, ACRS plus the credit still equals 110 percent expensing.

The real beneficiaries of the expensing break have been persons such as self-employed professionals, who have taken advantage of the rule to try to write off such things as the family car or home computer by buying in December and using the assets solely for business for a few days. (There are no effective rules for recapturing expensing write-offs when such assets are converted to personal use.) Given these problems, outright repeal of this expensing provision would be preferable.

2. **Restructure the basic system of depreciation and investment tax credits.** Despite the 1982 tax act's modest limitations, the Accelerated Cost Recovery System, in conjunction with the investment tax credit, continues to provide "negative" tax rates for most types of investments, particularly those financed by debt. Moreover, the tax treatment of different kinds of investments varies widely, and the inevitable distortions in capital allocation that result will cause our economy serious long-run harm unless they are quickly eliminated. Already we can see a proliferation of tax shelters built on ACRS, and more will certainly be on the way if action is not taken. Over the next several years, we hope the Committee and the Congress will reexamine the basic ground rules for writing off business investments in depreciable property. Our goal—and we hope yours—is to move toward a system with some close relation to the way equipment and buildings actually wear out, so that we can have a system that is reasonably neutral among different assets and that preserves the concept of a tax on net income.

This year, we offer the following specific suggestions toward achieving these goals:

a. **End double-dipping on investment tax credits.** Until recently, companies were allowed to take accelerated depreciation write-offs based on the full purchase price of new equipment, even though a portion of the cost is, in effect, paid for by the Treasury through the investment tax credit. The 1982 tax act partially corrected this double-dipping anomaly by disallowing depreciation deductions for half the amount of the regular investment tax credit. In 1983, Congress should finish the job begun in 1982 by requiring a "full basis adjustment." Moreover, this adjustment should apply not merely to the regular investment tax credit, but also to the 25 percent R&D credit, the energy credits, the ESOP credit, and the structure renovation credits.

b. **Lengthen the write-off period for structures to 20 years and toughen the recapture rules.** 1981's halving of the tax write-off period for structures has proven to be an enormous boon for tax shelter activity. This should not be confused, by the way, with a boom in real estate construction. In 1982, while construction workers were being laid off by the tens of thousands, real estate shelters were proliferating by the billions. *The Wall Street Journal* recently reported that "Public sales of real-estate tax-shelter partnerships soared to $2.7 billion last year from $1 billion in 1980, and they should rise to almost $4 billion this year." Unregistered, private offerings totalled as much as $20 billion in 1982, says the *Journal*, also a sharp advance. "It's like wildfire. I've never seen anything like it in my life," one long-time tax-shelter follower told the *Journal*.

The deals that the 1981 tax act has produced include last fall's $485 million purchase by 534 well-heeled investors of Metromedia, Inc.'s entire stock of 50,000 used billboards (see "Highway Robbery," *People & Taxes*, June 1983), the $137 million in cash put up by 450 investors to buy Continental Corp.'s New York City office tower (*The Wall Street Journal*, July 5, 1983), and the rampant trading in office buildings now underway in cities like Chicago.

Lengthening the write-off period for structures would put a dent in this activity, and might even redivert a little capital back toward more productive uses. We strongly support such a step, but we believe it should be accompanied by tougher recapture rules as well. The key to most real estate shelters—as opposed to legitimate business investments in stores and plants—is conversion of ordinary income to capital gains. Full recapture of all gains ought to be applied at least to property acquired used.

3. **Reduce tax incentives that encourage American companies to move their manufacturing and lending activities abroad.**

a. Runaway plants. No member of Congress favors tax subsidies for American companies to move their manufacturing operations offshore. But the tax code provides such incentives in several circumstances. We suggest the following changes in the tax laws to curb tax inducements for runaway plants:

(1) Allow the moratorium on IRS enforcement of the 861–8 regulations to expire. In 1981, Congress enacted a temporary suspension of IRS enforcement of its 861–8 regulations. These rules, which deal with the allocation of R&D expenses for purposes of calculating allowable foreign tax credits, were promulgated in 1977 to try to curb tax subsidies for foreign manufacturing. The justification for the moratorium was to give Treasury an opportunity to study the impact of the regulations on the location of research activities.

Treasury's report, submitted to Congress in June of this year, recommends an additional two-year moratorium. The body of the report, however, is at odds with that recommendation. Reportedly, the conclusion was reversed at the last minute based on considerations other than the merits.

Specifically, Treasury found that 85 percent of the $120 million to $240 million in added foreign tax credits produced by the moratorium accrues to 24 Fortune-100 corporations, that the eligible firms are actually less R&D-intensive than comparable companies, and that the tax break is of virtually no value to "small, relatively young high-technology firms." Moreover, Treasury found that the suspension had minimal impact in encouraging American R&D, in part because "foreign R&D is not highly substitutable for R&D performed in the United States."

Foreign manufacturing, on the other hand, may well be more easily substitutable for U.S. manufacturing. Since the benefits of the 861 moratorium are available only to companies with substantial foreign manufacturing operations, this presents a clear danger that the real incentive provided by the moratorium is to shift manufacturing jobs overseas. In sum, at best the 861 moratorium is simply a waste of a few hundred million dollars a year. At worst, it is positively harmful. In either case, we recommend that the suspension be allowed to expire.

(2) **Beef up section 367 of the tax code so that tax-free transfers of patents and know-how to foreign manufacturing subsidiaries are no longer allowed.** Current law allows companies to take advantage of generous U.S. tax breaks for R&D investments even when the fruits of those investments are employed to support foreign manufacturing operations and foreign jobs—often in tax-haven countries. We suggest changes in section 367 of the tax code so that transfers of patents and know-how abroad are not treated as tax-free "contributions to capital," but instead are treated as taxable exchanges or sales, so that the value of the exported R&D is subject to U.S. taxation and the tax breaks are recaptured. This should reduce one tax incentive for high-tech firms to export jobs.

(3) **Bring tax-haven manufacturing income within Subpart F in the case of products reimported into the U.S.** Recently, we have seen a number of U.S. firms moving part or all of their manufacturing operations to tax-haven jurisdictions and assigning a large portion of their total profits to such foreign operations when they reimport the products. In these circumstances, we suggest that deferral of U.S. tax on the foreign manufacturing profits be disallowed, by bringing the income within Subpart F of the tax code, which was designed to reduce the use of tax havens for tax avoidance purposes.

(b) **Runaway loans.** In recent years, we have seen an explosion in U.S. bank loans to foreign borrowers. In 1981, our banks's foreign loans outstanding went up by $90 billion—or 44 percent—and they jumped another $107 billion in 1982. At the same time, bank loans to domestic borrowers have been declining.[1] This surge in foreign lending has far outweighed the concurrent increase in foreign deposits into U.S. banks. In 1979, foreigners deposited $6 billion more into U.S. banks than the banks lent abroad. In 1981, foreign loans exceeded foreign deposits by $43 billion and in 1982 the deficit was $44 billion.[2]

The bias our banks seem to have toward lending to foreigners over providing credit to American businesses, farmers, and consumers appears to have at least some of its roots in the tax laws. The problem stems from the creditable status of foreign withholding taxes on interest combined with the overall (as opposed to the per-country) limit on the foreign tax credit computation. The following examples illustrate how the problem can arise.

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[1] *Economic Report of the President* (1983), Tables B–105 and B–63; Federal Reserve Bank of St. Louis, *International Economic Conditions*, April 21, 1983, p. 6.

[2] Federal Reserve Bank of St. Louis, *International Economic Conditions*, April 21, 1983, p. 6.

HOW U.S. FOREIGN TAX CREDIT RULES CAN CAUSE BANKS TO FAVOR FOREIGN OVER DOMESTIC LOANS

Assume the bank's cost of funds is 9 percent, that it lends at 10 percent (net of any withholding tax), and that loans to foreigners, when taxable in the foreign country, are subject to a 20 percent gross withholding tax (covered by charging a higher interest rate).

A. Loan to U.S. borrower:

Interest charged:	10.00%
Cost of funds:	–9.00%
Pretax profit:	1.00%
U.S. tax:	–0.46%
After-tax profit:	*0.54%*

B. Loans to foreign borrowers:

(1) No foreign tax, bank in excess credit position (more foreign tax credits from other sources than it can use):

Interest charged:	10.00%
Cost of funds:	–9.00%
Pretax profit:	1.00%
Pre-credit U.S. tax:	–0.46%
Foreign tax credit:	0.46%
After-tax profit:	*1.00%*

(2) 20% foreign gross withholding tax, bank in excess credit position, interest rate increased to cover tax:

Interest charged:	12.50%
Cost of funds:	–9.00%
Foreign tax withheld:	–2.50%
Pretax profit:	1.00%
Pre-credit U.S. tax:	–1.61%
Foreign tax credit:	1.61%
After-tax profit:	*1.00%*

(3) 20% foreign gross withholding tax, bank able to use additional foreign tax credits (i.e., not in excess credit position), interest rate increased to cover withholding tax:

Interest charged:	12.50%
Cost of funds:	–9.00%
Foreign tax withheld:	2.50%
Pretax profit:	1.00%
Pre-credit U.S. tax:	–1.61%
Foreign tax credit:	2.50%
After-tax profit:	*1.89%*

Apparently, situation B(3) is a simplified version of the most typical situation banks find themselves in with regard to loans to foreigners in countries such as Brazil.[3] As can be seen, the after-tax return on the foreign loan in B(3) is more than *triple* the after-tax return on a loan to a U.S. borrower. In such circumstances, it is not suprising that our banks seem to prefer to lend abroad.

This tax incentive for foreign loans would be reduced substantially if a per-country limitation on the foreign tax credit were in effect on such transactions. In example B(1), excess credits generated elsewhere could not be used to offset U.S. tax on the profit on the foreign loan. In example B(3), the credits could not be used to shelter other foreign income, making the result in B(3) the same as the result in B(2). Other approaches, along the lines of the "basket" rules for oil extraction income enacted in 1982 could also serve to curb the incentives for foreign lending at the expense of domestic borrowers.

4. **Crack down on tax shelters.** Despite claims by notables such as OMB Director David Stockman that the 1981 reduction in the top marginal tax rate to 50 percent would "effectively eliminate" tax shelters, upper-income taxpayers are not queuing up at the IRS to pay their tax bills. Instead, we have seen a tremendous growth in the tax shelter industry in the past year and a half. One analyst estimates that shelter activity increased by 53 percent in the first quarter of 1983 alone.[4] In the May 16 issue of *The New Republic*, James Glassman quotes an employee of Merrill Lynch as exclaiming: "Investors are out there like vacuum cleaners. You put out a [tax-shelter] product and they just suck it up."

As noted earlier, much of the blame for the surge in shelter activity can be laid on the excessively generous depreciation rules adopted in 1981. Economist Dale Jorgenson's warning that the shelter business generated by ACRS would deserve "its own line in the GNP accounts" appears to have been justified. We have already recommended scalebacks in those depreciation write-offs in an earlier part of this testimony. But there are a number of other steps that should be taken to curb shelter activity.

On June 24, the Treasury Department delivered detailed testimony to the Senate Finance Subcommittee on Oversight of the IRS outlining some of the tax shelter abuses against which it recommended action. In outline, the Treasury suggested:

- **A crackdown on tax straddles and similar transactions not covered by the straddle reform provisions of the 1981 tax act.** Some of these problems, involving offshore activity, would be dealt with by H.R. 3096, introduced by Representative Stark. Other areas in this category include abuses of stock option trading rules, avoidance of the limit on capital loss deductions through manipulation of short sales of stock immediately before dividend payments, conversion of short-term gains to long-term gains through mutual fund "capital gain dividends," and attempted avoidance of the accumulated earnings tax by tax-sheltered investment funds.
- **Restructuring a number of tax code provisions to reflect better the the time value of money.** Some of the problems here include overstatement of deductions by abuses of the accrual method of accounting, similar abuses of purchase money loans, and manipulation of interest-free loans to shift income from high-bracket to low-bracket taxpayers.

[3] *See* Surrey, "Some Tax Credit Issues in Relation to Developing Countries: Withholding Taxes on Interest Payments and Discriminatory Taxes," in *United States Taxation and Developing Countries* (1980).

[4] *See* Staff of the Joint Committee on Taxation, *Background on Tax Shelters*, June 24, 1983, p. 5.

- **Changes in the partnership rules with regard to allocation and timing of income and deductions.** Current law allows significant manipulations of partnership rules to obtain results unattainable by tax-shelter investors on their own. These include shifting income and deductions among partners, so-called prepayments of deductible expenses, and transfers of partnership interests tax-free in "like-kind" exchanges.
- **Curbs on inflated appraisals of appreciated property donated to charity.** This problem should be a familiar one to readers of *The Washington Post*. Last spring, reporter Ted Gup wrote a series of articles detailing how the curator of the gem collection at the Smithsonian Institution was cooperating with tax-shelter promoters to arrange donations of gems to the museum with tax appraisals typically about five times the gems' (recent) purchase prices.[5] Of course, this means that, counting revenue losses, the federal government was paying many times actual value for the gems.

We believe Treasury's suggestions are generally sensible, and we hope the Committee will give serious consideration to adopting them. In the area of inflated appraisals of donated property, we have an additional suggestion.

Treasury notes that the best way to solve the phony appraisal problem would be to limit charitable deductions for all appreciated property to the property's cost. This is also, Treasury points out, the most sensible approach from a pure tax policy viewpoint. But, Treasury admits, charitable organizations would vociferously protest such a reform, so Treasury recommends simply lengthening the holding period to qualify for "market-value" deductions for appreciated property.

We suggest a middle ground. Leave the loophole for easily valued property, such as stocks, bonds, and real estate, to satisfy the charities at least partially, but deny the tax break for hard-to-value property where the worst abuses occur. This result could be achieved by adopting the bill introduced last year by Representative Shannon to limit favorable long-term capital gains treatment to "productive" assets. An incidental result would be to wipe out the phony appraisal shelter for gems, coins, and so forth, since only assets eligible for long-term capital gains treatment can qualify for "market value" deductions.

5. **Other needed reforms.** We want to add our brief, but strong support for a number of other measures before the Committee, including:

- Representative Pickle's bills to curb sale-leaseback transactions by governments and tax-exempt organizations and to restrict the mushrooming growth of Industrial Revenue Bonds. With regard to the latter, we suggest also looking at a state-by-state dollar cap on total private-purpose issues. We are also intrigued by the recent proposal of Senators Dole and Long for a tax-credit alternative to mortgage revenue bonds.
- The Tax Law Simplification and Improvement Act of 1983, introduced by the Chairman and Representative Conable.
- The bill recently introduced by Representatives Stark and Conable to bring order to the tax treatment of nonstatutory fringe benefits.
- The efforts by Representative Stark to simplify and rationalize the tax treatment of life insurance companies.

[5] Gup's most unusual example involved Dr. Dale B. Dubin, a Florida plastic surgeon currently fighting with the IRS over whether he should be allowed a $1 million deduction for his gift to the Smithsonian of a topaz crystal he bought for $750.

In addition, we hope the Committee will have the opportunity to continue the progress begun in 1982 with regard to reducing tax incentives for mergers, in particular by curbing trafficking in net operating losses. The taxation of banks and financial institutions, notably excessive bad-debt reserve deductions and opportunities for tax arbitrage, should also be reexamined. At least some of the tax breaks for oil companies, on which hearings were held earlier this year, should be scaled back. And further improvements in tax compliance should be sought.

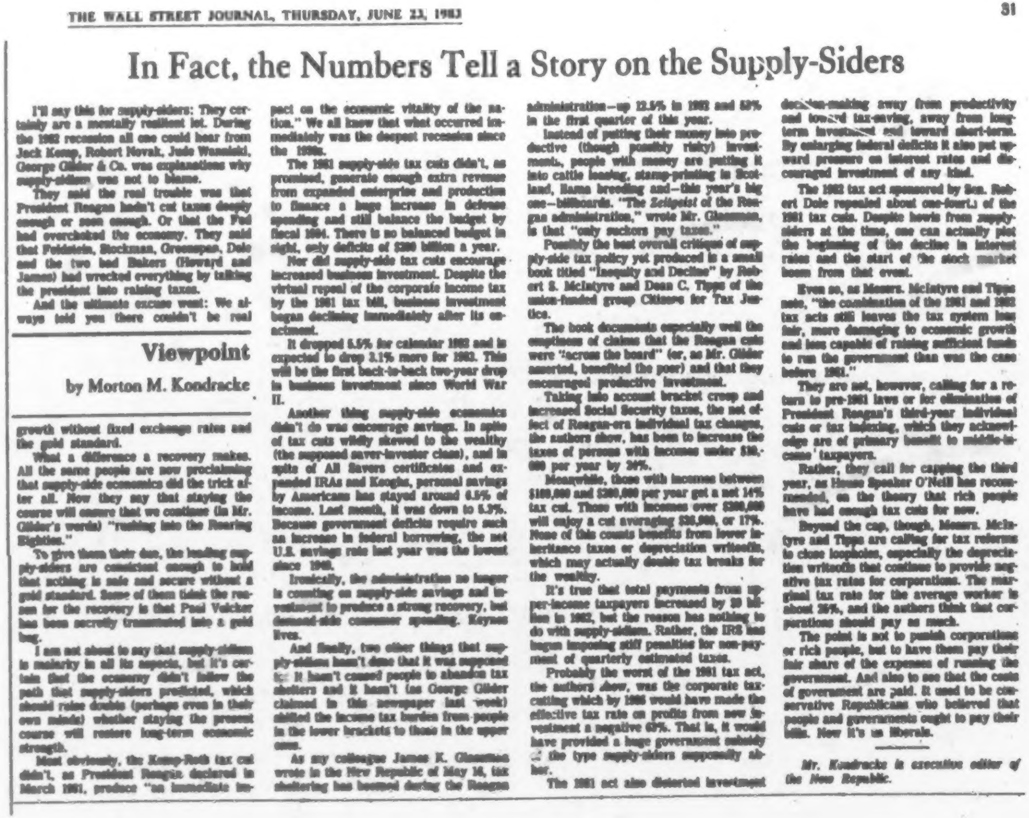
6. **Corporate minimum tax.** The process of tax reform is arduous and time-consuming, and the Committee is not likely to be able to deal with all problems this year. As a backup measure, we suggest an alternative minimum corporate tax of, say, 20 percent, on income exceeding a base amount, say, $100,000. Such an alternative minimum tax would be applied to a broad-based measure of corporate income similar to book income, and would apply only when regular tax liability fell below the minimum rate. In addition, the Committee should consider expanding the list of preferences subject to last year's 15 percent disallowance, and also increasing the disallowance rate to a higher percentage. Proposals to limit tax credits to 85 percent of tax liability also have merit.

7. **Reject the administration's contingency tax.** A key purpose for raising revenues this year is to assuage fears in the financial markets about huge future federal deficits and their effects on inflation and interest rates. A "contingency tax," the application of which is dependent on a number of uncertain conditions, is hardly an approach that makes sense in achieving this goal. If an income tax surcharge becomes a necessity, it should not be contingent and it should be progressive, to undo some of the damage to tax equity produced by the 1981 tax act.

CONCLUSION

The agenda before the Committee is a long one, and our testimony fails to do justice to a number of important proposals. Moreover, other good ideas are likely to surface during these hearings or later that we may support. We have recently published a book, *Inequity & Decline* (1983), which several members of this Committee have been kind enough to circulate to the Congress. We hope that book will be helpful in providing both more background and more detail on the kinds of tax policy issues covered in this testimony. In summary, we believe that this year's tax bill can be structured not only to raise revenues, but also to improve tax fairness and reduce tax-induced economic distortions. Such a result was achieved last year, and we are confident in the ability of this Committee to continue that progress toward a tax system that is worthy of the respect of all Americans.

ATTACHMENTS



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In Fact, the Numbers Tell a Story on the Supply-Siders

Viewpoint

by Morton M. Kondracke

I'll say this for supply-siders: They certainly are a mentally resilient lot. During the 1982 recession all one could hear from Jack Kemp, Robert Novak, Jude Wanniski, George Gilder & Co. was explanations why supply-siders was not to blame.

They said the real trouble was that President Reagan hadn't cut taxes deeply enough or soon enough. Or that the Fed had overchoked the economy. They said that Feldstein, Stockman, Greenspan, Dole and the two bad Bakers (Howard and James) had wrecked everything by talking the president into raising taxes.

And the ultimate excuse went: We always told you there couldn't be real growth without fixed exchange rates and the gold standard.

What a difference a recovery makes. All the same people are now proclaiming that supply-side economics did the trick after all. Now they say that staying the course will ensure that we continue (in Mr. Gilder's words) "rushing into the Roaring Eighties."

To give them their due, the leading supply-siders are consistent enough to hold that nothing is safe and secure without a gold standard. Some of them think the reason for the recovery is that Paul Volcker has been secretly transmuted into a gold bug.

I am not about to say that supply-sidism is malarky in all its aspects, but it's certain that the economy didn't follow the path that supply-siders predicted, which should raise doubts (perhaps even in their own minds) whether staying the present course will restore long-term economic strength.

Most obviously, the Kemp-Roth tax cut didn't, as President Reagan declared in March 1981, produce "an immediate impact on the economic vitality of the nation." We all know that what occurred immediately was the deepest recession since the 1930s.

The 1981 supply-side tax cuts didn't, as promised, generate enough extra revenue from expanded enterprise and production to finance a huge increase in defense spending and still balance the budget by fiscal 1984. There is no balanced budget in sight, only deficits of $200 billion a year.

Nor did supply-side tax cuts encourage increased business investment. Despite the virtual repeal of the corporate income tax by the 1981 tax bill, business investment began declining immediately after its enactment.

It dropped 5.5% for calendar 1982 and is expected to drop 3.1% more for 1983. This will be the first back-to-back two-year drop in business investment since World War II.

Another thing supply-side economics didn't do was encourage savings. In spite of tax cuts wildly skewed to the wealthy (the supposed saver-investor class), and in spite of All Savers certificates and expanded IRAs and Keoghs, personal savings by Americans has stayed around 6.5% of income. Last month, it was down to 5.3%. Because government deficits require such an increase in federal borrowing, the net U.S. savings rate last year was the lowest since 1948.

Ironically, the administration no longer is counting on supply-side savings and investment to produce a strong recovery, but demand-side consumer spending. Keynes lives.

And finally, two other things that supply-sidism hasn't done that it was supposed to: It hasn't caused people to abandon tax shelters and it hasn't (as George Gilder claimed in this newspaper last week) shifted the income tax burden from people in the lower brackets to those in the upper ones.

As my colleague James K. Glassman wrote in the New Republic of May 16, tax sheltering has boomed during the Reagan administration—up 12.5% in 1982 and 52% in the first quarter of this year.

Instead of putting their money into productive (though possibly risky) investments, people with money are putting it into cattle leasing, stamp-printing in Scotland, llama breeding and—this year's big one—billboards. "The *Zeitgeist* of the Reagan administration," wrote Mr. Glassman, is that "only suckers pay taxes."

Possibly the best overall critique of supply-side tax policy yet produced is a small book titled "Inequity and Decline" by Robert S. McIntyre and Dean C. Tipps of the union-funded group Citizens for Tax Justice.

The book documents especially well the emptiness of claims that the Reagan cuts were "across the board" (or, as Mr. Gilder asserted, benefited the poor) and that they encouraged productive investment.

Taking into account bracket creep and increased Social Security taxes, the net effect of Reagan-era individual tax changes, the authors show, has been to increase the taxes of persons with incomes under $10,000 per year by 20%.

Meanwhile, those with incomes between $100,000 and $200,000 per year got a net 14% tax cut. Those with incomes over $200,000 will enjoy a cut averaging $36,000, or 17%. None of this counts benefits from lower inheritance taxes or depreciation writeoffs, which may actually double tax breaks for the wealthy.

It's true that total payments from upper-income taxpayers increased by 30 billion in 1982, but the reason has nothing to do with supply-sidism. Rather, the IRS has begun imposing stiff penalties for non-payment of quarterly estimated taxes.

Probably the worst of the 1981 tax act, the authors show, was the corporate tax-cutting which by 1986 would have made the effective tax rate on profits from new investment a negative 63%. That is, it would have provided a huge government subsidy of the type supply-siders supposedly abhor.

The 1981 act also distorted investment decision-making away from productivity and toward tax-saving, away from long-term investment and toward short-term. By enlarging federal deficits it also put upward pressure on interest rates and discouraged investment of any kind.

The 1982 tax act sponsored by Sen. Robert Dole repealed about one-fourth of the 1981 tax cuts. Despite howls from supply-siders at the time, one can actually plot the beginning of the decline in interest rates and the start of the stock market boom from that event.

Even so, as Messrs. McIntyre and Tipps note, "the combination of the 1981 and 1982 tax acts still leaves the tax system less fair, more damaging to economic growth and less capable of raising sufficient funds to run the government than was the case before 1981."

They are not, however, calling for a return to pre-1981 laws or for elimination of President Reagan's third-year individual cuts or tax indexing, which they acknowledge are of primary benefit to middle-income taxpayers.

Rather, they call for capping the third year, as House Speaker O'Neill has recommended, on the theory that rich people have had enough tax cuts for now.

Beyond the cap, though, Messrs. McIntyre and Tipps are calling for tax reforms to close loopholes, especially the depreciation writeoffs that continue to provide negative tax rates for corporations. The marginal tax rate for the average worker is about 26%, and the authors think that corporations should pay as much.

The point is not to punish corporations or rich people, but to have them pay their fair share of the expenses of running the government. And also to see that the costs of government are paid. It used to be conservative Republicans who believed that people and governments ought to pay their bills. Now it's us liberals.

Mr. Kondracke is executive editor of the New Republic.

When D.C. talks, market listens

Study says Dole tax act, not Ron, set off stock rally

ECONOMY AT LARGE

By JEROME CAHILL

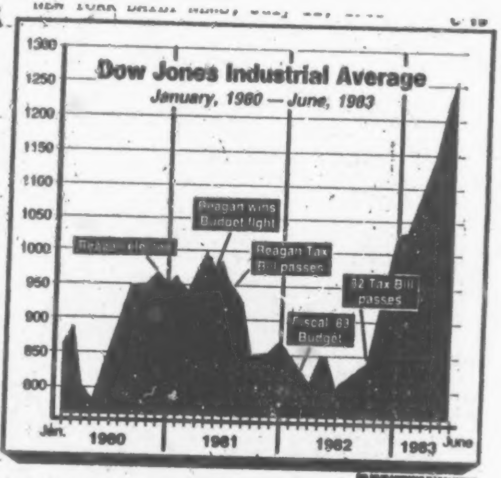
WASHINGTON—In their new book on President Reagan's tax program, "Inequity and Decline," Robert S. McIntyre and Dean C. Tipps have charted Wall Street's responses to milestones in the era of Ronald Wilson Reagan.

It is a fascinating exercise, recording the market's ebullience over Reagan's election in 1980, its enthusiasm for his budget-cutting, and its progressive disenchantment with the 1981 tax cut package and the first Reagan budget.

THE CHART on Page 96 is of more than historical interest, however. It shows how the market rallied in the wake of an unusual phenomenon: a tax-increase measure, the three-year, almost $100 billion package of revenue-raisers Senate Finance Committee Chairman Bob Dole (R-Kan.) pushed through Congress last summer in an effort to bring order to the country's chaotic fiscal condition.

That rally, dubbed by McIntyre "the Dole tax reform boom," pushed the Dow Jones Industrial Average to 1280 in mid-June.

But it has since weakened amid fears the Federal Reserve Board is about to tighten credit again, in no small measure because of those looming $200 billion-plus deficits on the horizon that Congress and the White House seem unwilling to confront.



IF THE DOLE boom continues to fizzle, McIntyre, Tipps and their colleagues at Citizens for Tax Justice, a public-interest tax-reform group, hope history will repeat itself and pressure for another tax bill will increase.

They have a long list of tax-reform candidates for inclusion in such a measure, not the least of which are a batch of proposals to scale back some of the business tax breaks in the 1981 act.

McIntyre reports some quickening of interest in the possibility of another tax-reform bill, especially if it can be packaged with a tax cut for low-income Americans. They, he contends, got nothing out of the 1981 three-year rate reduction because inflation outweighed the rate cuts for those at the lower end of the tax scale.

"Because of inflation, the lower half of the population is paying 80% more in federal income taxes than they did five years ago," he says. "And the next 30% has had a 14% tax increase, despite the Reagan tax cuts."

To rectify the situation, McIntyre is urging an increase in the minimum standard deduction, which currently exempts from federal taxation the first $3,400 earned by a married couple and the first $2,300 earned by a single taxpayer. The deduction hasn't been changed since 1977.

THE HOUSE will hold hearings on revenue proposals this month, but the serious business of drafting a bill won't begin until September.

Democrats, in the meantime, will be keeping an eye on President Reagan. If he opposes the tax-reform effort and labels his rivals "tax and spend" enthusiasts, that could be enough to end the effort right there.

It's just possible, though, that the market may speak more eloquently, just as it did last year.

Legislative Highlights

LOOPHOLE OF THE MONTH: HIGHWAY ROBBERY

Late last fall, 534 wealthy Americans got together to make an unusual purchase. They bought 45,000 billboards, Metromedia, Inc.'s entire stock of outdoor signs.

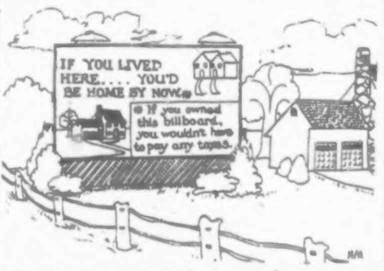
The investors have no interest in roadside advertising. What they are interested in is avoiding taxes. And that they will do. Despite a seemingly inflated price of more than $10,000 per billboard, the 534 investors have been promised profits of as much as $200 million ($375,000 each) over the next five years.

Every nickel of these profits will come at the expense of Uncle Sam — and average taxpayers. In fact, the deal involves nothing but shuffling paper. Metromedia will continue to manage the business side of the project and, after five years, is expected to buy the billboards back. Thereafter, it will garner huge tax breaks on its own.

Informed sources say that the $485 million transaction — which will generate exactly zero dollars in new investment — is almost certainly the largest syndicated tax shelter offering ever.

The poster panels that are producing this massive cash transfer out of the pockets of ordinary folks and into the bank accounts of wealthy investors and one of the country's fastest growing corporations are not exactly social policy winners — even as billboards go. Forty-one percent of them promote cigarettes and another 21 percent push alcohol. In fact, the prospectus for the deal cautions that part of the partnership expenses will go for lobbying to keep the government from restricting this kind of outdoor advertising.

How does a deal like the "Outdoor Advertising Associates, Limited Partnership" work? Well, one key is that only a small fraction of the cost of the billboards was actually provided by the doctors and executives who bought into the shelter. They anted up a mere $150,000 each, for a total of $80 million, only 16 percent of the overall purchase price. And, of their $80 million, about 20 percent was skimmed off immediately in expenses and fees to middlemen, including $9 million to Bear, Sterns & Co., the investment banking firm that engineered the deal. Another $3.4 million went to lawyers and accountants who helped out.


IF YOU LIVED HERE.... YOU'D BE HOME BY NOW.*
* If you owned this billboard, you wouldn't have to pay any taxes.
KM

The bulk of the money to buy the highway signs was borrowed, including a $70 million loan back to the tax-shelter partnership by Metromedia itself and $350 million put up by a consortium of banks, led by Citibank. In addition to receiving 15.5 percent annual interest, by the way, the banks extracted $3 million in "arrangement" and "facility" fees for their trouble.

The individual participants in the billboard shelter probably don't care much about a little profit-taking on the part of the organizers of the deal. In fact, wealthy taxpayers lined up in droves to give Bear, Sterns their money. The program was so quickly filled that Bear, Sterns was able to set up "a waiting list of additional subscribers" in case any of the early birds should decide to drop out.

The investors' enthusiasm was not surprising. Bear, Sterns projects almost a 43 percent after-tax annual return for participants — the equivalent for these 50 percent bracket individuals of an 85 percent pretax return (not even counting state and local tax savings). This is almost 5 times the going rate on tax-exempt municipal bonds and 8 times the after-tax return on federal government long-term issues.

Over the five years they will own the billboards, the investors expect to write off about a third of their investment as "depreciation," even though Bear, Sterns estimates that the actual value of the signs will *go up* by over a third. And, while the write-offs will be worth 50 cents on the dollar in tax savings, the gain when the billboards are sold back to Metromedia will be taxed at only 20 percent — due to the special treatment of capital gains.

Bear, Sterns' projections about the future value of the road-side attractions may be optimistic, but even if the pretax rate of return on the billboard shelter turns out to be zero (that is, after five years the investors simply get their money back), the after-tax annual return from write-offs will average 28 percent — five times the after-tax return on Treasury bonds. Even if the investors get *none* of their money back, they will still earn more than 11 percent annually, which is also greater than the after-tax yield on government bonds.

They can't do worse, since they have no personal liability to pay back the loans. The tax code's "at risk" restrictions, which limit some kinds of shelters financed with borrowed money, don't apply to "real estate" like billboards (nor do provisions "recapturing" some excessive depreciation when property is sold).

The tax shelter prospectus doesn't concern itself with why Metromedia finds the temporary sale of its billboards advantageous, but one lucrative scenario is apparent. When Metromedia buys its displays back after five years, it will get a new "basis" for tax depreciation of about six times the $111 million "book" value of the billboards before the tax shelter deal was entered into. And, as "newly-acquired assets," the signs will be eligible for fast depreciation write-offs under the Accelerated Cost Recovery System (ACRS).

The net result is that Metromedia will be entitled to about 10 times the annual depreciation write-offs that it had before the sale and buyback of the billboards. The added deductions will be much greater than the short-term costs to Metromedia from the deal. Metromedia will thus have deftly circumvented restrictions on such asset "churning" included in the 1981 tax act.

Shelters involving billboards could be closed, but it would take more than mere tinkering. Unlike some currently popular tax avoidance schemes, the billboard shelter doesn't require any shady game-playing. Nor is it premised on not being audited. Instead, the highway placard deal is simply a very large, very unusual example of the standard real estate shelter as it now exists under the Reagan regime.

The relatively straightforward nature of the billboard shelter makes it much more frightening than deals that might be curbed by better enforcement or small technical changes in the law. Equally scarifying is the overall proliferation of tax shelter transactions that is now occurring.

Jim Glassman reports in *The New Republic* that even though 1982 was a weak year for oil and real estate shelters, overall syndicated offers increased 13 percent. And in the first quarter of 1983, they jumped another 53 percent. OMB Director David Stockman's 1981 prediction that the cut in the top tax rate from 70 to 50 percent would "effectively eliminate" the shelter industry has proven slightly hyperbolic. Contrary to his supposition, wealthy investors who were previously unwilling to pay 70 percent have failed to queue up at the IRS to pay 50 percent.

Glassman attributes the shelter surge in part to the Administration's glorification of self-interest and denigration of government. "In the process," he notes, "they have made avoiding taxes seem a noble pursuit." There's probably truth in this analysis (see "Of Consumers and Entrepreneurs — Why Supply-Side Fosters Moral Prostitution," *P&T*, May 1983). But shelters, including billboards, were given an even more important boost by the huge new loopholes in the President's 1981 tax program, most notably the ACRS fast depreciation write-offs.

The Reagan administration's term in office has featured numerous record-setting accomplishments on the tax and economic fronts: Biggest deficits in history. Deepest recession and highest unemployment rate since the 1930s. Lowest national savings rate (in 1982) in the post-war era (breaking the 1949 record). Largest volume of mergers in a single year ($82.6 billion in 1981). Lowest corporate tax collections (fiscal 1983, in constant dollars) since Pearl Harbor.

The latest "supply-side" milestone — the biggest syndicated tax shelter deal in history — helps explain why all those other records have been shattered at the same time.■

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WALL STREET JOURNAL, 7/5/83

Real-Estate Tax Shelters Booming, But Critics Move to Trim Benefits

By Randall Smith
Staff Reporter of The Wall Street Journal

The 450 investors buying Continental Corp.'s New York City office tower are getting much more than just a chunk of Manhattan real estate. In the first seven years that they own the tower, they will chip in $305,000 each in cash. But in the same period, they each stand to gain tax deductions projected at $672,000. Assuming the investors are in high tax brackets, the tax savings alone will exceed the cash outlay.

While the investors will technically own the building, the insurance company the building is named for has guaranteed to lease it for 30 years and pay all operating costs, making the risk minimal. "It isn't hard to see how these deals always sell out so quickly," says Disque Deane, chairman of Corporate Property Investors, a large real-estate investment trust.

Even while the office rental market is still in a slump and the housing recovery has just begun, real-estate tax shelters like this one are booming. But the more the shelters grow, the more vulnerable they become. The boom results largely from a 1981 change in the tax laws governing depreciation that makes the deals more attractive than before. Now a move to trim back the new tax advantage is gaining momentum in Washington. Its backers say the rapid growth of the shelters proves that the tax benefit is too generous.

Surge in Sales

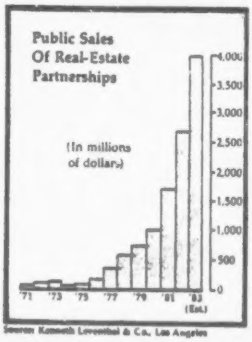
Public sales of real-estate tax-shelter partnerships soared to $2.7 billion last year from $1 billion in 1980, and they should rise to about $4 billion this year, says Kenneth Leventhal & Co., a Los Angeles accounting concern that tracks such sales.

Besides such public partnerships, registered with the Securities and Exchange Commission, private partnerships sold without SEC registration totaled between $8 billion and $20 billion last year, also a sharp advance from previous years, Leventhal adds. "It's like wildfire. I've never seen anything like it in my life," says Mr. Deane.

The 1981 tax-code change helping the boom shortens the "depreciable life" of income-producing property to 15 years from a previous range of 30 years to 50 years. Depreciation allows an owner to deduct over time a property's cost from taxable income. The new 15-year schedule gives the owner of a $100 million building an annual deduction of $6.7 million, instead of only $2 million to $3.3 million under the old rules.

The tax-code changes were meant to stimulate construction. But the change is expected to cost the Treasury about $4.3 billion in the fiscal year ending Sept. 30 and more than $10 billion in the year ending Sept. 30, 1986. With Congress grasping for ways to close huge budget deficits, the real-estate tax shelters are becoming a tempting target.

"There is a great deal of revenue loss being generated that's producing no positive economic activity," says a Senate Finance Committee staff member. Some property owners "are just sort of trading properties around" to enhance their deductions, he adds.



Source: Kenneth Leventhal & Co., Los Angeles

The 15-year depreciation rule is "one of the largest targets" for those who want to take back some of the '81 business tax incentives, says an aide to Democratic Rep. Dan Rostenkowski, chairman of the House Ways and Means Committee. Rolling back the depreciation to 20 years "is an option on a lot of lists," he adds.

On the Republican side, Senate Finance Committee Chairman Robert Dole is reportedly reluctant to make another change in the depreciation rules because they were changed in both 1981 and 1982. But aides talk of changing the rules to block "churning," sales of existing buildings, allowing new owners to gain the 15-year depreciation and a higher price basis for the deduction. The Finance Committee has encouraged an Internal Revenue Service crackdown on all sorts of abusive tax shelters, including some that involved inflated real-estate write-offs.

Some in Washington are especially concerned about lease-back deals. Financial corporations with relatively low tax bills, such as Continental Corp. and First National City Bank of Houston, have sold new buildings to real-estate tax-shelter partnerships and leased them back. As the tax benefits are a primary benefit to investors, these deals are often called "depreciation strips."

Local governments and other tax-exempt institutions find the deals alluring too. Reginald Todd, an aide to a Texas Democrat on the House Ways and Means Committee, J.J. Pickle, notes that Washington, D.C.; Atlanta; Battle Creek, Mich.; and San Jose, Calif., are thinking of selling their city halls in leaseback sales of convention centers; Philadelphia may sell a jail, and Bennington College in Vermont may sell its entire campus, Mr. Todd notes.

Rep. Pickle introduced a bill last month to curb such lease-back transactions by tax-exempt entities. He warns that the practice could lead to "staggering revenue losses," create billions of dollars worth of new tax shelters and foist "shaky financing schemes" on the public.

Sharing the Benefits

Meanwhile, the partnerships are making money for plenty of people, including the syndicators who sell them. These entrepreneurs buy properties and then resell them to groups of investors called syndicates or partnerships. The investors share in the income, appreciation and tax deductions that their properties generate. The syndicators collect sales commissions and fees. Of the $137.3 million in cash to be invested in the new Continental Tower, some $36 million, or 26%, will go for fees to the syndicators and others. These fees equaled 16% of the $221 million total purchase price.

Integrated Resources Inc., whose biggest activity is real estate partnerships, says its profit surged to $22.4 million last year, up 52% from 1981. Revenue of $176 million last year was more than double the level two years earlier. The company's stock, which closed on the New York Stock Exchange at $41 Friday, has more than tripled in value since mid-1982.

Until lately, six big companies, including Integrated Resources, have dominated the field. But lately, the big financial "supermarkets" have increased their stake in the business. American Express Co. last year bought one of the six big syndicators, Balcor Co., which has since doubled its property partnership sales. Merrill Lynch & Co., the nation's largest securities concern, started

Please Turn to Page 33, Column 1

Boom in Real-Estate Tax Shelters Sparks Moves to Reduce Benefits

Continued From Page 21

its own syndication unit in 1978, and has doubled its volume every year since then.

In addition to the tax-law changes, syndicators have benefited from inflation, which has bolstered their track records. JMB Realty Corp., a large syndicator, says that since 1971 it has sold properties costing $52 million for $132 million.

The syndicates also benefit from declining returns of some other kinds of tax shelters and from the nature of real estate investment. Syndicates can purchase a building for a small down payment and take a large mortgage. As they base depreciation on the total purchase price and deduct the mortgage interest as well, they can obtain tax deductions far greater than the cash investments.

Because mortgages have the property as collateral, investors don't risk being forced to repay loans that turn sour. In most other types of tax shelters, they do.

Private partnerships generally involve more borrowing and more risk than public partnerships, but tend to provide bigger tax breaks. Unlike public partnerships, which must demand payment all at once, private partnerships can allow investors to pay in their cash over several years. This lets investors' tax deductions exceed cash payments for several years, which helps private partnerships to raise cash.

In the past year, private partnerships have rocked the industry with huge deals. Chicago's VMS Realty Inc. has announced the purchase of two hotels and an office building for a total of about $290 million. Integrated Resources plans to acquire the Mellon Bank headquarters in Pittsburgh and resell it to one of its partnerships for about $280 million.

For all the fear of tax law revisions,

THE WASHINGTON POST Sunday, July 10, 1983 B 5

Is High Tech Unpatriotic?

We're giving tax breaks so Atari can ship jobs overseas

By George W. McEntee

PUBLIC OPINION POLL (multiple choice): Do you think it makes sense for U.S. tax laws to encourage high-tech American firms to move their manufacturing plants abroad?

(a) Yes.
(b) No.
(c) Hell, no!

Don't spend too long trying to choose between (b) and (c). The official correct answer — or at least the apparent consensus among elected officials in Washington — is (a).

To be sure, most of our representatives don't want to encourage a shift of manufacturing jobs overseas. Instead, they think they're promoting American research and technology.

So-called "Atari Democrats," along with most Republicans, are the leaders in inadvertently promoting answer (a), so it's appropriate that last spring's decision by Atari, Inc. to lay off 1,700 American workers and transfer its computer assembly operations to Hong Kong offers an apt illustration of the perverse impact of current tax rules.

Certainly the lure of cheap labor was a factor in Atari's going abroad. But the tax code clearly provided additional incentives.

U.S. companies can defer taxes on foreign profits while still taking advantage of generous tax breaks for the R&D investments which create that income.

Consider Atari, which invests lots of money researching and developing new products in this country. It is allowed tax deductions for those costs, and in some cases also gets a federal R&D tax credit. The deduction saves Atari about 50 cents in federal and state taxes for every dollar invested, and the credit can add another 25 cents in tax savings. This leaves Atari's out-of-pocket cost for a dollar's worth of R&D somewhere between 25 and 50 cents.

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If Atari uses its know-how to manufacture products in California, the government will tax the profits. But it's still a sweet deal for Atari. The company keeps at least half the profits, while putting up as little as a quarter of the capital outlays.

By shifting its production offshore, however, Atari has found a way to do even better. The government will continue to pay for 50 to 75 percent of Atari's R&D, but now it will get no share of the profits the R&D generates. As long as Atari reinvests its earnings abroad, U.S. taxes are indefinitely deferred. And, since Atari has carefully chosen to put its runaway plants in low-tax or tax-haven countries like Hong Kong, Ireland, and Taiwan, it won't have to pay any significant foreign taxes either.

But, you may say, now that the Atari situation is a *cause celebre*, the administration and Congress will certainly figure out what's going on and crack down on tax subsidies for exporting jobs. Don't bet on it. Our lawmakers seem intent on making things worse.

Last month, the Treasury Department recommended giving a couple of hundred million dollars a year in extra foreign tax credits to multinational firms that — you guessed it — do research in the United States to support foreign manufacturing operations.

The purpose of this tax break, its numerous congressional supporters claim, is to stimulate R&D here at home. What they fail to consider, however, is that the real incentive can be to shift manufacturing jobs offshore. By definition, the added tax credits are available only to companies with large foreign operations.

The foreign tax credit bonus at issue would extend a "temporary" measure enacted in 1981 and scheduled to expire this year. Pushed by Atari Democrats and ITT, this measure blocked the IRS for two years from enforcing its "Section 861" regulations — rules promulgated in 1977 to try to curb tax subsidies for foreign manufacturing.

The 1981 law required the Treasury to analyze the impact of suspending the 861 regulations and report its findings to Congress this year. In May, Treasury staff dutifully completed a draft study that found the loophole unjustified. But then politics intervened.

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Under pressure from congressional Republicans and multinational companies, Treasury Secretary Donald Regan ordered a last minute reversal of the report's conclusion.

Among other things, Treasury's analysis shows that almost all the money from the tax subsidies goes to 24 giant corporations and that the extra tax credits provide minimal stimulus to American R&D.

Treasury also found that the loophole is of virtually no value to "small, relatively young high-technology companies." These firms don't benefit because they haven't yet started exporting jobs.

If we wanted to stop paying companies to ship jobs overseas, the best first step would be to repeal the rule allowing deferral of taxes on foreign profits, as suggested by Presidents Kennedy, Carter and the AFL-CIO. Short of that, we could at least stop Atari-USA from transferring its patent and know-how to Atari-Hong Kong tax-free. Current law is vaguely supposed to limit such tax-avoiding transfers, but in practice it rarely succeeds.

In addition, Congress should allow the IRS to enforce its suspended foreign tax credit regulations — preferably in strengthened form.

Preserving American jobs ought to be politically popular, but, unfortunately, subsidies for "high tech" are the current rage in Washington.

Gerald W. McEntee is president of the American Federation of State, County and Municipal Employees. He was assisted in the preparation of this article by Robert E. McGarrah Jr. of AFSCME.

With llamas, Scottish stamps, and rent-a-cows.

HOW TO BEAT THE I.R.S.

BY JAMES K. GLASSMAN

"INVESTORS are out there like vacuum cleaners," said an official of Merrill Lynch in mid-April. "You put out a product and they just suck it up." The product is tax shelters—not small-time shelters like Individual Retirement Accounts, but sophisticated shelters like equipment-leasing partnerships and oil and gas income funds.

The boom in tax shelters is taking place at the very time supporters of Reaganomics told us it wouldn't. One of the blessings of the Reagan tax cuts, we were continually assured during Congressional debate in 1981, would be that they would chase people out of unproductive tax shelters and into productive—and taxable—investments. The theory went as follows: someone in a 50 percent bracket might be encouraged by his high marginal tax rate to seek shelter in a cattle-feeding scheme or a leveraged real-estate deal. But with his bracket cut to 40 or 45 percent, his tax savings wouldn't be so great, so he'd invest instead in common stocks paying taxable dividends or in Treasury bonds paying taxable interest. It was an attractive idea: lower tax brackets would yield higher tax revenues. Alas, things haven't worked out so neatly.

Instead of eliminating shelters, the Reagan Administration seems to have encouraged them, in part by crowning them with legitimacy. The President and his supporters have glorified self-interest, while at the same time denigrating government. In the process, they have made avoiding taxes seem a noble pursuit. A headline in a slick magazine called, believe it or not, *National Tax Shelter Digest* sums up the new ethic: YOUR RIGHT AND DUTY TO TAX SHELTER INCOME. A prospectus on a real-estate tax-shelter deal sponsored by Quantum Corporation of Marina Del Rey, California, brags that the 3.3-for-1 tax write-off comes courtesy of the "influential real-estate lobby." And tax-shelter promotion, once the province of some of the sleaziest financial operators in the country, is now practiced by such respectable firms as Merrill Lynch and American Express.

Whether Reagan's economic policies have actually encouraged shelters may be open to debate, but recent reports make it clear that the tax cuts haven't produced the promised results. Instead, according to Robert A. Stanger & Co., a respected firm that publishes a newsletter on tax shelters, Americans in 1982 put $9 billion into "tax-advantaged investments"—in other words, sophisticated shelters (limited partnerships rather than I.R.A.s and municipal bonds). In 1981 the figure was less than $8 billion. That's an increase of 12.5 percent in a year when inflation was less than 5 percent. What is even more remarkable is that this growth occurred in a year when the two most popular shelter industries, oil and real estate, were having a miserable time. With oil prices dropping and real estate difficult to sell, shelters still thrived.

Now, in the first quarter of 1983, with oil and real estate recovering, shelter sales are soaring. Stanger reports that investments in "public" shelters (those registered with the Securities and Exchange Commission) are 53 percent higher than they were during the same period last year. "They're rewriting the record books," Stanger said. Investment in public and private sophisticated shelters will probably exceed $11 billion in 1983; that's nearly eight times the 1977 level of $1.4 billion. The tax cuts clearly have not dampened the popularity of shelters. To understand why, you have to understand how a shelter works.

"Dear Prospective Investor," writes Jeffrey Adler, executive vice president of Ag Asset. "We at Ag Asset, the nation's largest dairy cow management company, thank you for your inquiry regarding our 1982 Dairy Cow Leasing Program." Dairy cow management? Are we about to help Heidi lead Bossy through a grassy meadow? Actually, the prime aim of dairy cow management, according to a brightly colored prospectus that features lots of pictures of healthy Holsteins, is "substantial tax benefits." Here's how it works: you put up $15,000 and Ag Asset arranges a loan for you for $22,500. Of the total, $7,500 goes to commission and fees for the promoters (a common trait of shelters is that promoters are nicely compensated) and $30,000 goes to buy cows that are then leased to farmers. The rent-a-cow business is particularly attractive because cows can be depreciated quickly, over five years, and because cows, like printing presses or die-casting machines, are assets that qualify for the investment tax credit. In all, during the first year, that $15,000 cash outlay throws off $19,061 in deductions to a taxpayer in a 50 percent bracket, which begins at $41,500 for single people and $85,600 for married couples filing jointly. And for the next four years, with no extra investment, you get another $4,000 to $5,000 in annual write-offs. A first-year write-off of 1.3 to 1 ($1.30 in deductions for every dollar you put up) is probably not high enough to attract the attention of the Internal Revenue Service. Among the taxpayers who have sheltered their income with aid from the bovine set is Yoko Ono.

BUT COWS ARE chicken feed. When a serious taxophobe like Attorney General William French Smith is looking for a shelter to call his own, he turns to oil. As an investor in Yale-Quay Energy Partners, a drilling venture in Oklahoma, Smith put up $16,500 in 1981 and received a deduction that year of $66,000—a 4-for-1 write-off. In 1982, another $16,500 investment gave him $33,000 in deductions. The key to Yale-Quay, and to many other high-multiple shelters, is that the taxpayer gets tax benefits immediately for the full value of an investment while putting up cash for only a small portion of that investment. When does the taxpayer cough up the remaining portion? A long time after he's taken the write-offs—at which point, he's probably found another shelter. As lawyer Stephen L. Hester described the Yale-Quay scheme at a Congressional hearing last September, investors can "buy $4,000 of immediate tax deductions for $1,000 down, so long as they promise to pay the remaining $3,000 at some time or other—perhaps in 1993."

The hottest shelters these days are Arabian horses and other fancy animals (*National Tax Shelter Digest* is running an ad touting investments in llama breeding in Oregon), cable TV, hotels, and stamps. The major incentives are leverage, fast depreciation (hotel furnishings can be written off in five years, for example, making hotels better shelters than most real estate, which is written off in fifteen years), and the investment tax credit (yes, llamas qualify).

A particularly nifty maneuver nets a 4.2-for-1 deduction the first year and a 4-for-1 deduction the second on an investment in stamps from three obscure islands off Scotland called Bernera, Eynhallow, and Staffa. The key is a high evaluation of a "stamp master," the plate used to print the stamps. An investor puts up $12,000 the first year—$2,000 for production costs (not deductible, alas) and $10,000 for leasing the master. He gets deductions of $10,075 (the leasing cost plus $750 in accrued interest). And he gets a $20,000 investment tax credit (10 percent of the full value of the stamp master even though the investor is putting up only 5 percent of the master's value the first year). It's a wonderful deal. Say you're a married lawyer with a taxable household income of $80,000. You put up $12,000 for the Scottish stamps, and you get $10,750 in deductions, knocking your taxable income down to $69,250, which makes your tax bill $22,237. Then you apply the investment tax credit to that, and your total tax bill is just $2,237. Without the Scottish stamps, your bill would have been $27,505. You've made yourself $25,000 richer with an investment of $12,000 in a tax shelter.

READING THE PROSPECTUS for the Scottish stamps gave me a feeling of déjà vu. I had been through almost the same routine before, in a meeting room in the Mayflower Hotel three years ago. Instead of a stamp master, the tax-shelter promoters were touting lithographic plates by famous artists. The idea is to have the investor "purchase," with a relatively small amount of cash, something whose value is difficult to judge. The premise is similar to a far simpler scam: you buy a truckload of old books for $1,000, get a friendly bibliophile to assess them at $4,000, and donate them to charity. You get a 4-for-1 write-off, or an immediate cash-flow profit of $1,000 if you're in the 50 percent bracket.

Roscoe L. Egger, the current I.R.S. Commissioner, describes a particularly outrageous variation on the theme. A record master worth $100 was evaluated at $250,000 and leased to investors who took enormous investment tax credits. The law even allows them to carry the credits back and apply them to previous years' returns. And the I.R.S. is required to send out refunds on these old returns within ninety days. "The promoter," says Egger, "will lend investors the cash, at 20 percent interest, to invest in the scheme. Upon receipt of the quick refund, the investor pays off the loan from the promoter." The shelter in question resulted in the I.R.S. giving out $57 million to $62 million in credits to 5,200 taxpayers.

What's infuriating about these tax shelters with high write-offs is that many of them are clearly illegal—yet despite new tools provided by the 1981 and 1982 tax laws, the I.R.S. can't do much about them. It's snowed under with work. When Jerome Kurtz, the I.R.S. Commissioner under President Carter, left office, 200,000 cases involving possibly abusive shelters were waiting to be reviewed. Today that backlog has grown to 300,000 cases. "There is something wrong with tax administration," Kurtz said last fall, "and what is wrong is the absence of adequate resources to move these cases."

The I.R.S. isn't the only enforcement agency that's understaffed. The Tax Division of the Justice Department has just ten lawyers working on illegal shelters, even though Egger estimates that abusive shelters cost the Treasury $3 billion a year. Over the past four years, only 469 shelter cases have been sent to the Justice Department for prosecution, and only 48 cases have ended in convictions.

Although the Reagan Administration may have helped create an atmosphere in which tax shelters, legal and illegal, can thrive, it actually has a better record than the Carter Administration for getting laws enacted that help enforcement. In the past year, the number of prosecutions, although minuscule, has increased, and the I.R.S. is now going after promoters—tax-shelter packagers and lawyers and C.P.A.s who give favorable rulings to questionable schemes—as well as taxpayers. But the penalties aren't tough enough. And even if they were, it's doubtful that they would deter promoters; the rewards are very high, and the risks, given the voluntary nature of our tax system and the favorable odds in what Egger calls "the audit lottery," are very low.

TRYING TO CURE the problem through tighter enforcement is probably futile. Reagan, in fact, may have the right approach: drive people out of tax shelters through structural change in the tax law. Unfortunately, the structural change that he thought would work—cutting marginal tax rates—has failed. And it's failed for an obvious reason: everyone likes tax deductions, and everyone can use them. It's true that those in 50 percent brackets can use them to better advantage, but those in lower brackets can make out pretty well themselves. A shelter that provides $4,000 in deductions for every $1,000 invested knocks $2,000 off the tax bill of someone in a 50 percent bracket, but it still knocks $1,400 off the bill of someone in a 35 percent bracket. Hearings before the House Subcommittee on Select Revenue Measures a year ago made this point emphatically. The committee looked at the tax returns of people who were engaged in door-to-door or telephone sales part time, working for companies like Amway and Shaklee. Although the companies themselves don't condone the practice, these taxpayers frequently use their part-time work as a ruse to convert nondeductible personal, living, and family expenses into deductible business expenses. One example cited in the hearings was a taxpayer who made $20,000 in his regular job and $5,000 through direct selling. But he wrote off $6,586 for business use of his car, $848 for the cost of meetings in his home, $515 for entertainment, and $1,766 for a home office. His total business deductions came to $21,000, and his total business loss to $16,000. He threw in $4,000 in personal exemptions and wiped out his entire tax bill for the year. The point here is that the fellow was making only $20,000. He was in a 25 percent tax bracket. And yet he went to extraordinary lengths to score deductions.

A better approach than to lower marginal tax rates would be to eliminate deductions and credits entirely, or almost entirely, and adopt a flat or slightly graduated tax of the sort proposed in bills introduced by Senator Bill Bradley of New Jersey and Representative Richard Gephardt of Indiana. (See "Flat-Rate Talk," by Robert S. McIntyre, TNR, July 19 & 26, 1982.)

CHANGING the entire tax code just to pick up the $3 billion that escapes the I.R.S. each year because of abusive shelters sounds drastic. But tax shelters are only the most obvious symbol of what's wrong with the U.S. Tax Code: it's complex and unfair and (Reagan is right on this score) it encourages unproductive economic activity. The inequity in the code is more horizontal than vertical. In other words, the big problem is not that rich people don't pay high enough taxes; most rich people do. (Only 9 percent of families making more than $200,000 in 1980 paid less than a quarter of their gross income in taxes.) It is that people who make the same gross income pay widely varying tax bills. And the ones with low tax bills receive that blessing for reasons (like investing in llamas and Scottish stamps) that make no economic or ethical sense. This inequity encourages cynicism and disrespect for law and government, and it encourages an attitude that seems to suit the Zeitgeist of the Reagan Administration: only suckers pay taxes.

There are 104 categories of "tax expenditures," or loopholes, in the Tax Code, and it can be argued that a tax shelter—which is merely the most sophisticated form of loophole—far from being antisocial or antigovernment, is an ethical instrument. Shelters are there because Congress, in its wisdom, wanted to encourage specific beneficial activities—building low-cost housing, getting industry to renew its plant and equipment, encouraging people to insulate their houses. But once written into the law, loopholes tend to stay. And tend to be exploited by sharp lawyers and accountants. Many of the justifications for the 104 loopholes are lost to history. They offend our sense of equity, and they push us into questionable behavior. We go into debt rather than saving. We buy houses we can't afford. If Congress wants to encourage certain kinds of economic and social behavior, it should do so directly, by appropriating funds, not by using the Tax Code. The I.R.S. is having a tough enough time just collecting what's owed.

Legislative
Highlights

LOOPHOLE OF THE MONTH: CHARITY IN FORM ONLY

President Reagan has said he believes in tithing — in giving 10 percent of his income to religious and charitable causes. Of course, the President also says he believes in a balanced federal budget, so it's not surprising to find that Mr. and Mrs. Reagan's 1982 tax return shows charitable contributions amounting to only 1.3 percent of their $1.25 million in total earnings (see box).

Well, maybe it's the thought that counts. But the Reagans do seem awfully cheap compared to their fellow members of the million-dollar income club. At first glance, most individuals in that super-rich category appear to have put the President's preaching about tithing into practice. In 1981, they took charitable deductions totalling just about exactly 10 percent of their adjusted gross incomes. The average deduction claimed was a whopping $209,000 per wealthy contributor.

But don't be too hasty in condemning the Reagans. A look behind the raw data suggests that the President and his wife may just be more honest, no less generous, than other wealthy families. As it turns out, a large proportion of the charitable contributions claimed by the well-off on Form 1040 are charity in form only.

Item. A recent series by reporter Ted Gup in the *Washington Post* discloses that the Smithsonian's gem curator from 1967 to 1982 cooperated with tax-shelter promoters to arrange gifts to the Smithsonian of jewels and other precious stones appraised for tax-deduction purposes at five times or more their purchase prices.

Item. A follow-up story by Gup details the case of Dr. Dale B. Dubin, a Florida plastic surgeon, who currently is fighting with the IRS over whether he should be allowed a $1 million deduction for his gift to the Smithsonian of a topaz crystal he bought for $750.

Item. An article in the April issue of *Harper's* describes a sunken-treasure shelter, in which investors will donate the recovered artifacts to museums and take deductions for many, many times their investment in the salvage operation.

Item. One "abusive" tax shelter under investigation by the IRS involves the purchase of Bibles by a tax-shelter syndicate and the subsequent donation of the sacred texts to religious organizations — with appraisals for tax purposes of five to 10 times the books' cost.

The phony-appraisal shelter is one of the most popular and hard-to-police loopholes available to the rich. Over the years, its variants have involved artworks, original manuscripts and musical scores, historical-preservation easements, Presidential (and Vice-Presidential) papers, and even pornographic movies.

As fast as Congress has dealt with a particular horror story, a new one has surfaced. In 1981, some 500,000 disputes involving significant property-valuation questions were outstanding, with about $2.5 *billion* in taxes at stake. And these cases, which are currently clogging the Tax Court, are just the tip of the iceberg, since the IRS audits only a small percentage of tax returns.

The key to the phony-appraisal shelter is that the donated objects be unique — and therefore relatively hard to value. In other words, the ideal gift is a "collectible" — or, as some might call it, a "non-productive asset." For items with a closer relation to the world of commerce, such as stocks, bonds, and real estate, it's harder to pick an appraisal out of the air without leaving oneself open to charges of criminal tax fraud. (There are tax-shelter problems even with donations of property-valued items, but they are of a somewhat different sort.)

In 1981, Congress finally did take an across-the-board stab at curbing inflated-appraisal abuses. It established stiff penalties on taxpayers who knowingly overvalue donated property. The fines start at 10 percent of the attempted tax savings for overstatements of 50 to 100 percent and rise to 30 percent for overstatements of more than 150 percent. In 1982, an additional 10 percent penalty was imposed on tax-shelter promoters who provide appraisals of more than double an object's true worth.

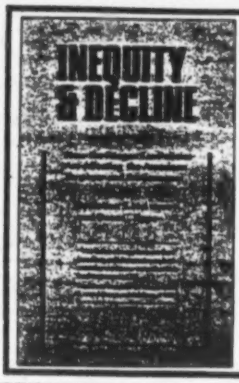
But, given the IRS's extremely thin audit coverage, penalties alone will not solve the phony-appraisal problem. The *Washington Post* has suggested one effective answer: deny all deductions for non-cash donations. If the owner of a collectible (or, for that matter, stocks or real estate) wants to give the object to a museum, he or she can simply sell it and give the museum the proceeds, which the museum can then use to buy the article.

Representative James M. Shannon (D.-MA) has proposed another, more targeted solution. His bill would deny capital-gains tax breaks to sales of "non-productive assets" such as gold and collectibles. An incidental effect would be to wipe out the phony-appraisal shelter, since current law already limits deductions for donations of assets not eligible for capital-gains breaks to the cost of such assets.

Either approach is sensible, but clearly something ought to be done. Dr. Dubin was caught, and the Reagans knew their return would be checked by the IRS. But for too many wealthy taxpayers, phony appraisals provide irresistible odds in the tax-audit lottery. ■

CHARITY BEGINS AT HOME

[illegible] Reagans' 1982 tax returns showed $1.2 million in total income, including $200,000 in Presidential salary, $247,000 in interest, and $790,000 in capital gains [illegible]



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People & Taxes

Lease-A-Government

BY TYLER BRIDGES

At first glance, it was an obscure provision, one of the many pieces of graffiti written onto the Economic Recovery Tax Act of 1981. Later, many Senators and Representatives protested that they had never known it was part of the tax bill. But corporate financial managers, accountants, and tax lawyers were fully aware of the meaning of "safe-harbor leasing."

Overnight, a high-powered industry emerged to trade in tax credits and deductions. Companies that had "zeroed out" because their supply of loopholes exceeded their ability to use them, sold their "excess" tax benefits to companies still on the tax rolls in almost riskless paper shuffles.

Likened to a food stamp program for corporations, safe-harbor leasing allowed some highly profitable companies to pay no federal corporate income taxes in 1981. General Electric, an aggressive player, even collected a $100 million refund from past years' taxes. In only a few months of frenzied activity, safe-harbor leasing cost the federal Treasury at least $10 billion and perhaps as much as $15 billion in fore gone tax revenues.

It didn't take long, however, for safe-harbor leasing to become known throughout the U.S. — as a symbol of the unfairness of President Reagan's 1981 tax program. An outraged public forced Congress to halt the fast and furious "tax-benefit transfers" as part of the 1982 tax reform act.

But now, even as tax reformers and fiscal conservatives are still congratulating themselves for putting a tourniquet on Treasury's revenue hemorrhage from leasing, a close relative of safe-harbor leasing has appeared on the doorstep that could dwarf in scope its kissin' cousin.

This time it is not giant corporations that are selling the tax breaks. Instead, it is cities, counties, colleges, and even federal departments that want to get into the act, through unprecedented and imaginative uses of an older form of tax leasing, called "sale-leaseback" or "leveraged leasing."

Governmental bodies and tax-exempt organizations selling tax breaks? How can it be? How can institutions that don't pay any taxes have any loopholes to vend?

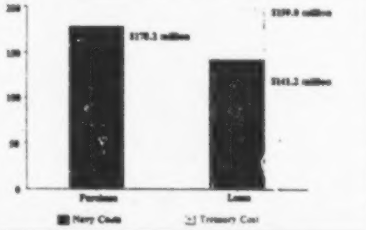
Strange as it may seem, however, tax-exempts *are* beginning to enter the tax-break marketplace. Bennington College, an expensive and exclusive liberal arts school in Vermont, for example, is arranging to transfer ownership of its campus buildings to alumni and lease them back. The city of Atlanta wants to sell and rent back its town hall, as does the city of Corpus Christi. Libraries, sewer systems, town art centers, and public school systems are all on or headed for the auction block.

Even federal agencies are itching to get a piece of the action. The Air Force wants to rent 120 CT-39 executive aircraft and 202 tanker transport bombers. The National Oceanic and Atmospheric Administration wants to sell and lease back its weather satellite system. The Department of Energy would like to "privatize" the controversial Clinch River Breeder Reactor.

"This thing is so big, it could amount to the biggest atom bomb in public finance in this century," says Representative J.J. Pickle (D-TX), Capitol Hill's leading critic of the burgeoning traffic in tax leasing by tax-exempt organizations.

The proponents of the new approach offer a different assessment. City managers, college presidents, the Secretary of the Navy, tax attorneys, and others view sale-leaseback as a savior, a cheap and innovative way to fund programs in a time of fiscal austerity, while avoiding costly and time-consuming federal regulations.

TAKX Cargo Ship
Purchase Vs. Lease Costs



Cargo ships leased

A look at the most celebrated government leasing deal, which involves the Navy, suggests that Rep. Pickle has the better of the argument.

Last fall, the Navy told Congress that it wanted to rent rather than purchase outright 13 TAKX cargo ships worth $2.3 billion for the Rapid Deployment Force, in a transaction involving General Dynamics, Waterman Steamship Corp., and Maersk Line Ltd.

Under the terms of the leveraged lease, the Navy would pay about $174 million a year to lease the ships— a total of $4.4 billion over the 25 year term of the lease. The Navy currently points out that the "present value" of the rental payments, taking into account the time value of money, is only $1.8 billion (including the cost of buying the boats at the end of the lease term).

What the Navy doesn't properly take into account, however, is the net effect of the various tax breaks the deal will create. The staff of the Joint Committee on Taxation estimates the *total* cost to the government of leasing the ships (in "present value" terms) to be at least $2.6 billion — 12 percent more than an outright purchase.

Of course, there's no reason to expect the Navy to care about the higher overall cost to the federal government. Leasing would clearly be cheaper *for the Navy* — and would allow it to shift 30 percent of the cost of its ships from its budget to the federal Treasury's "tax expenditure" budget. At a time when Congress is beginning to take a closer look at defense spending, this is no mean trick.

Admiral Merrill Lynch

All sale-leaseback deals work the same way as the Navy's end-run around the budget — and share its drawbacks. Basically, a non-taxable agency or organization arranges to have a private group buy or construct some big-ticket item. The nominal owners, being taxpayers, get to claim a number of tax benefits, such as accelerated depreciation, interest deductions, and the investment tax credit.

The tax-exempt organization then signs a long-term lease at a price reflecting a pass-through of some share of the lessor's tax benefits. The paper owners — who now "own" the city's fire station, the university's basketball pavilion, the Defense Department's newest jet fighter, or whatever — are happy because their tax bills have been reduced at virtually no risk.

The agency or organization is happy because its budget looks smaller. But federal taxpayers will end up footing the bill for all of this — and paying much more than if they had simply given direct subsidies to the governments or tax-exempt groups.

"If this kind of thing continues, we're going to see E.F. Hutton own the Air Force, and Merrill Lynch rule the waves," says Rep. Pickle. "Can you imagine the average taxpayer's response? It's no wonder that citizens are losing confidence in the tax system."

Critics say the Treasury Department and the Office of Management and Budget should be concerned about the waste and increased deficits inherent in the federal leasing deals. So far, these agencies have not taken a position — perhaps because most of the added costs from leasing will be the problems of future administrations.

In the case of cities and tax-exempt groups, there are virtually no checks on irresponsibility, since the added costs of leasing are borne by federal taxpayers, not by the local organizations.

"What we have here is an open invitation for groups to back their trucks up to the federal Treasury and load up, no questions asked," says a congressional aide. "It's a back-door method of public finance."

Tax shelter of the 1980s

Only a few cities, counties, colleges, or other tax-exempt institutions have actually completed sale-leaseback deals. "There's more talk than action thus far," says Jacque Schlenger, a tax attorney with the Baltimore firm of Venable, Baetjer, & Howard. "But I think a lot of deals will be consummated this year." One real estate expert calls leveraged leasing the tax shelter of the 1980s.

City officials acknowledge that sale-leaseback financing is a tax shelter. But they say these deals are necessary because of cities' poor fiscal situation.

On top of the recession, federal

budget cuts have made the task of balancing city budgets a Houdini-like skill. Among the local programs the Reagan administration has slashed funding for are: Community Development Block Grants, the Historic Preservation Grant Fund, Urban Development Action Grants, and funds for constructing waste water treatment plants.

Cities and counties have also turned to sale-leaseback financing to obtain extra money to pay for the increasingly dilapidated infrastructure. One study reports that at least 50 percent of the nation's communities are unable to support any significant level of economic growth until major investments are made in rebuilding their deteriorating roads, sewers, bridges, and mass transit systems. The Environmental Protection Agency estimates that by the year 2000, more than 21,000 waste water treatment plants will be required at a cost of almost $100 billion.

"We face an infrastructure problem of crisis proportions," says Frank Shafroth, legislative counsel at the National League of Cities, which recommends that cities arrange sale-leaseback deals whenever possible.

Traditionally, cities have met their financial needs by issuing tax-exempt bonds. But increasingly skeptical voters have been more reluctant to approve bond issues, and interest rates cities pay on the tax-exempt bonds have risen to historically high real levels. "The market for municipal tax-exempt bonds has virtually dried up," says Joan Bannon, assistant executive director of the U.S. Conference of Mayors.

Many analysts have pointed out, however, that one of the main reasons why cities are being forced to pay such high interest rates on municipal bonds is the total lack of restraint they have shown in "renting" their tax exemptions to private businesses, which can then issue tax-exempt Industrial Development Bonds.

Tax-free bonds for private purposes now constitute well over half the tax-exempt market. Sale-leaseback deals, which typically involve the use of IDBs, would make the problems even worse.

Other cities, particularly those in California and Massachusetts because of state-wide ballot initiatives, have had difficulty issuing bonds because they are limited in how much they can go in debt. "We aren't willing to say that cities of Massachusetts should be flushed down the drain because the voters approved Proposition 2½ years ago," says Shafroth.

"Cities are in bad shape, and they need help," agrees Robert McIntyre, Director of Federal Tax Policy at Citizens for Tax Justice, a coalition of public interest and labor groups. "But sale-leaseback financing is a hopelessly inefficient way to help them.

"You don't have to understand the complex arithmetic to realize that leasing costs the federal government much more than handing out subsidies directly," says McIntyre. "Somehow or other the government must pay more, if only because of the middlemen involved — who will presumably want to be paid for their services."

"Cities say they need help," adds Rep. Pickle. "But what about the federal government? What shape is the federal government — and the economy — going to be in if we have even greater deficits?"

Innovative city managers

City officials respond that they are following the principles of the Reagan administration's New Federalism program. Because of federal budget cuts and the Administration's reluctance to help cities rebuild their infrastructure, "it seems like Reaganomics is saying this is the way cities should be run today," says John Flores, assistant city manager in Oakland, who sold the city's museum and convention center and then leased them back as a substantial budget savings.

"Local governments have been forced to be fairly inventive," says Tom Lewcock, city manager in Sunnyvale, Calif., who arranged to sell the city's public library to a limited partnership and then lease it back. Sunnyvale is using the money from the deal to construct a new public safety building.

"Washington has cut off the spigot," adds Howard Braitman, a CPA with Price Waterhouse in Philadelphia, who is consulting with cities to sell real estate that qualifies for the 25 percent historical preservation tax credit, an additional tax break. "Any city that doesn't take advantage of sale-leaseback financing is stupid," Braitman says.

Rep. Pickle is not waiting to see how widespread sale-leaseback financing becomes. He has already begun drafting legislation to "squeeze the juice out of sale-leaseback transactions."

Pickle wants to eliminate the tax breaks governments and tax-exempt organizations can offer. He would also require any agency considering a leveraged lease deal to factor in the federal tax expenditure in the overall project cost.

"I think Congress will crack down on sale-leaseback financing before it is unleashed on the American public," Pickle says. Sen. Howard Metzenbaum (D-OH) has indicated he will offer similar legislation.

Fat-cats and alcoholics

Michael Hooker, president of Bennington College, strongly opposes any congressional action to interfere with his scheme to lease and lease back much of Bennington's campus. Bennington is negotiating a "lease-leaseback" deal to avoid paying state property taxes and still take advantage of federal tax breaks.

"I find tax shelters appalling," says Hooker. "But if Congress is not going to eliminate all tax shelters," he says, "then it shouldn't cut off the leveraged lease shelter. It helps the nation's colleges and universities, which are in bad shape financially. Sale-leaseback is in the national interest, since it funds higher education.

"Besides," Hooker adds, "this is money Washington would never see. The money would otherwise be going into the pockets of fat-cat real estate operators and oil companies."

Responds Rep. Pickle: "That's like an alcoholic saying, 'If I don't drink that bottle of whiskey, then someone else will.'"

Adds CTJ's McIntyre, "Obviously moral philosophy, not to mention economics, is not on Bennington's curriculum."

At least 10 other colleges and universities have already completed leveraged lease deals. Hooker reports that from the publicity the Bennington deal has gotten, he has received over 25 calls from other schools, including a couple of prominent Ivy League universities.

"The leveraged lease industry is still in its infancy, so it's important to act now," says Pickle. "The genie's not out of the bottle yet.

"Before long, we'll be up against an entrenched special interest group. A 'National Tax-Exempt Leasing Association' will have been created, and tax lawyers and accountants will be traveling around the country promoting leveraged lease deals."

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"I find tax shelters appalling," says Bennington College President Michael Hooker. "But if Congress is not going to eliminate all tax shelters, then it shouldn't cut off the leveraged lease shelter."

"This thing is so big, it could amount to the biggest story going in public finance in this century," says Rep. J.J. Pickle.

People & Taxes

If Economic Recovery Is Underway, Credit Keynes, Not Arthur Laffer

BY ROBERT MCINTYRE

"Some of my friends think President Reagan was just too doggone optimistic," says the pert, fortyish lady, looking up from the antique table she is refinishing. "But, you know,... the economy *is* starting to come around... People are going back to work because President Reagan didn't go for the quick fix. Maybe we can all be a little more optimistic about the future."

This 30-second television spot, titled "Number 2 Optimist" and paid for by the Republican National Committee, illustrates the message about the economy the Reagan administration would like the public to believe.

"Getting our economy back on sound footing has been a long, tough haul, and the job isn't done yet," President Reagan said in February. "But evidence grows that the worst of what we inherited is behind us. The economy is improving. Recovery has begun."

Indeed, almost daily, some new statistic seems to indicate that the long-promised economic rebound may be finally under way. Housing starts are up, factory orders have increased, and the unemployment rate appears to have leveled off.

Not all the news is good. Retail sales fell in February for the third straight month. Wages and salaries also declined in February, as did the number of hours worked. And business investment remains sickly.

Even the stabilization of the unemployment rate is suspect. Employment actually declined by 180,000 jobs in February, but was more than matched by an increase in the number of people too discouraged to continue looking for work.

But, assuming that some kind of recovery is in the cards this year, the question remains whether "Reaganomics" deserves any of the credit. Are the "supply-side" effects of the 1981 economic program finally taking hold? Will the performance of the economy in the months ahead be a fair gauge of the merits of the President's "trickle-down" economic philosophy?

"The answer," *Business Week* recently pointed out, "is no. Reaganomics as originally conceived and implemented is dead. What will now be put to the test is its successor, Reaganomics II — a policy that bears a striking resemblance to Keynesian economics."

What *Business Week* calls the death of Reaganomics was represented by the 1982 tax reform bill, which repealed some of the worst elements of the sadly-misnamed Economic Recovery Tax Act of 1981. But the '82 tax act did not come close to solving all the problems of Reaganomics I, and the remaining legacy of that program threatens to make whatever recovery we experience in 1983 both weak and unsustainable unless further corrective action is taken.

Back in March of 1981 President Reagan presented his program as a painless quick-fix for the economy. "Our tax proposal," he said, "will, if enacted, have an immediate impact on the economic vitality of the nation." Six months later he added, "I firmly believe that our tax incentives will act as a new battery for the American economy, recharging and energizing the nation with economic opportunity."

The "incentives" that the President was banking on to produce an "investment-led recovery" consisted primarily of sharp reductions in corporate income taxes. Although the individual tax cuts received most of the media attention, "bracket creep" and higher social security taxes more than wipe out the tax cuts for the overwhelming majority of middle- and lower-income Americans. Only the very wealthy actually receive significant real tax reductions.

The corporate tax cuts, on the other hand, were so enormous that Roger Altman, a former assistant Treasury secretary now with the Wall Street firm of Lehman Brothers, told the *Washington Post*: "The tax bill has virtually phased out the corporate tax in America."

The 1981 corporate tax changes were centered on a gargantuan new loophole called the "Accelerated Cost Recovery System," which provided much faster write-offs for plant and equipment investments. Combined with tens of billions of dollars in added breaks for particular industries and companies, the corporate reductions were expected to cut federal revenues by over $500 billion during the 1980s. The provisions were so generous that the Administration added the now-notorious "tax leasing" rules so that firms with an overflow of write-offs and credits could sell them to other companies.

Despite all the new tax "incentives," the prospects for an "investment-led recovery" began to unravel almost before the ink was dry on the 1981 tax act. Instead of embarking on a period of sustained growth, the economy entered a deep recession.

A year after the program and its rosy scenario were first unveiled, the Reagan administration was scaling back its optimistic projection of real growth in the Gross National Product for 1982 from 4.2 percent to 0.2 percent — a 95 percent drop. As it turned out, even this later prognostication was too cheery. The recession that followed enactment of the President's program continued to grow deeper and deeper.

Interest rates, which were supposed to start a long decline, ascended to back-breaking "real" levels (actual rates minus inflation) — stifling business investment and crippling the housing and auto industries, problems that soon spread to the economy as a whole. Unemployment skyrocketed to its highest rate since the Great Depression. The promises of a tiny deficit in fiscal 1983 and a balanced budget by 1984 were replaced by predictions of the largest deficits in U.S. history — approaching or exceeding $200 billion in fiscal 1983 and beyond.

Even the stock market plummeted. The sharp reduction in the maximum tax rate on capital gains, made effective June 10, 1981, was supposed to be a boon to the stock market. Reacting to real economic signals rather than to supply-side rhetoric, however, Wall Street turned darkly bearish. The Dow-Jones Industrial Average quickly fell 100 points following passage of the tax bill, and by the spring of 1982 was down close to 200 points.

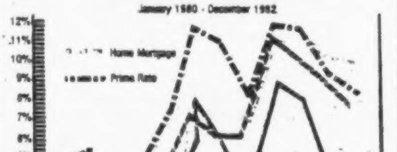
Particularly striking was the decline in business investment. The Administration had contended its corporate tax cuts would spur business investment and create jobs. Instead, spending by businesses on plant and equipment dropped. By the summer of 1982, real business spending on plant and equipment was down more than 7 percent from the time the 1981 tax bill was enacted.

Administration officials have been unable to find even isolated instances where the tax cuts have boosted business investment. "This Administration... has provided just what American industry said it needed to transform our economy," complained Treasury Secretary Donald Regan to a group of business leaders in Indianapolis in September 1981. "Yet I must stand here and ask: Where is the business response?... It's like dropping a coin down a well — all I'm hearing is a hollow clink."

Real Interest Rates Are Still High

(NOMINAL RATES MINUS INFLATION)

January 1980 - December 1982



Nine months later in the June 1982 issue of *The Atlantic*, Gregg Easterbrook wrote of interviews with Treasury Undersecretary Norman Ture and John Chapoton, Assistant Secretary for Tax Policy. When asked for any evidence of increased investment generated by the new corporate tax cuts, Chapoton "acknowledged that he could not cite a company that had increased investment because of the tax cuts." Ture, asked the same question, gave virtually the same response.

The lack of business response to the tax cuts should not have come as a surprise. The tens of billions in corporate tax "incentives" enacted in the 1970s also had failed to add to the level of business capital spending. Even before the tax bill was passed, *Business Week* in July 1981 disclosed that many executives "claim that their investment plans do not turn on tax cuts," but rather on "assurance that there will actually be demand for their products."

Six months later, as the recession deepended, an official of the National Business Machine Tool Builders Association stated bluntly, "There's just no incentive for a guy to go out and buy machines when he's got machines sitting idle all day."

And the chairman of Northwest Industries told The *New York Times* in January 1982: "With or without the tax bill we would have done what we did in 1981 and what we plan to do in 1982. One can spend money on men and materials only at a given rate. Beyond that it becomes foolish."

So where did all the money provided by the corporate tax cuts go? The answer is that, instead of investing in new productive ventures, corporate executives found other ways to put the increased cash flow from their tax bonanza to work.

According to W.T. Grimm & Co., a Chicago-based merger consulting firm, the number of corporate mergers jumped 27 percent in 1981 and the total dollar value of mergers almost doubled, from $44.3 billion in 1980 to $82.6 billion in 1981. In 1982, the number of mergers just about matched the record 1981 level.

In addition, many corporations channeled their new tax benefits into dividend payments. Dividends in 1981 reached historically high levels — up 12 percent from 1980, despite the recession's dampening effect on sales, jobs, and production levels. In 1982, dividend payouts continued to rise.

Top executive salaries rose 16 percent in 1981, *Business Week* noted in May 1982, on top of a 14 percent hike the year before. This was double the rate of increase in wages for rank-and-file workers, whose earnings failed to keep up with inflation for the second year in a row.

In an article titled "The Capital Spending Bust," *Newsweek* in December 1981 succinctly summed up the business response to its new tax windfall: "Companies appear to be using their increased cash flows for everything but new plants and equipment."

Keynesian Stock Market

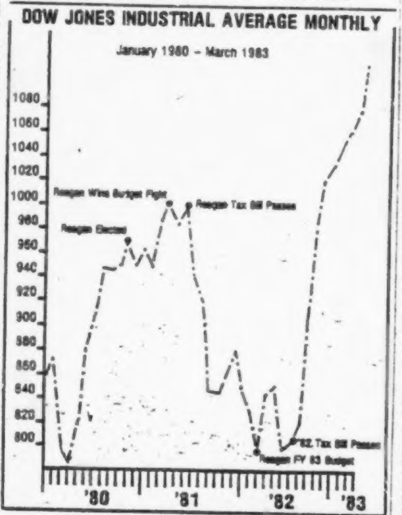


CHART BY [illegible]

SOURCES: 1982 and 1983 *Economic Report of the President; The Wall Street Journal* March 15, 1983

It seems clear that the corporate tax cuts in the 1981 tax act, far from stimulating new business investment, actually helped depress it. The added loopholes played a principle role in creating the specter of huge and growing federal deficits in future years. These long-run deficits, in turn, meant the government would be competing for a very large share of the limited credit available in the economy for the foreseeable future.

The threat of this enormous government borrowing helped push up interest rates, particularly long-term rates, to record real levels. These high interest rates then discouraged or "crowded out" private investment in plants, equipment, autos, and housing, overshadowing the short-run stimulative effect of current deficits. This directly stifled the economy.

For these reasons, contentions by some diehard supporters of corporate tax relief that the Administration's incentives never had a chance to work because of the recession — or that the recession would have been even worse without the business tax cuts — are unconvincing. Such claims simply ignore the basic interaction between fiscal and monetary policies.

Claims that the Administration's business tax cut program never had a fair chance are further undermined by a McGraw-Hill survey at the beginning of 1982, when the Reagan administration still was predicting a strong recovery and when polls showed that business executives still believed in the Reagan policies. The survey asked companies what share of their then-planned capital spending for the year they attributed to the "incentives" provided by the 1981 tax act. The answer was a mere $1 billion, or less than 0.3 percent of what the companies then expected they would invest.

Yet the 1981 tax act slashed corporate taxes for 1982 alone by some $14 billion — more than a 20 percent decrease in taxes and 14 times the added investment even the act's corporate proponents were willing to say the act stimulated. Moreover, by November 1982 the companies surveyed by McGraw-Hill had cut their full-year investment budgets by $21.5 billion from their beginning-of-the-year predictions. This reduction overwhelmed the miniscule investment gain these ardent loophole backers earlier had tried to attribute to the 1981 act.

Not only did the corporate tax cuts fail to increase investment, they also distorted the marketplace and subsidized some industries and investments far more than others.

About 80 percent of the faster depreciation write-offs was targeted to the country's largest 1,700 firms — the top 0.1 percent of America's companies. Testifying on an early version of the Reagan corporate program, the Small Business Legislative Council told a Senate Finance Subcommittee, "It would be difficult to write a tax bill better designed to speed the extinction of small businesses."

Over this decade, oil and gas interests were granted at least $60 billion in accelerated depreciation tax breaks, plus another $20-30 billion worth of reductions in the oil windfall profit tax. And the $60 billion from faster depreciation does not include the additional billions of dollars in tax cuts going to the oil companies as a result of their extensive non-oil-and-gas holdings in industries such as mining, chemicals, plastics, retailing, office equipment, and so on.

The new depreciation write-offs and credits were also sharply biased in favor of short-term investments. The 1982 *Economic Report of the President*, in a surprising display of candor, showed how these biases could hurt the long-run growth prospects of the economy. Investments in industrial plants, for example, would need to be over four times as profitable before tax as investments in office equipment or trucks in order to compete on the after-tax bottom line. As a result, said the *Economic Report*, "the composition of the capital stock will be altered and national output will be produced less efficiently."

"We are talking about wasting a large portion of our capital formation, our precious investment dollars," Harvard economist Dale Jorgenson had told the Ways and Means Committee in May 1981. "Those precious dollars are going to be diverted into tax shelters. We are going to create, to use David Stockman's famous simile, a 'coast-to-coast corporate soupline.'"

In 1981, Congress chose to ignore warnings like Jorgenson's about the critical flaws in the Reagan corporate tax reductions program. But by mid-1982, as the failure of Reaganomics was becoming clearer and clearer, Congress acted to undo some of the worst excesses of 1981.

The 1982 Tax Equity and Fiscal Responsibility Act was a backlash bill — a backlash against the tax policies of 1981, which contributed to the deepest recession since the 1930s and the largest long-term peacetime federal deficits in history. It was also a backlash against the inequity of the 1981 law, which provided enormous real tax cuts for the wealthy and virtually eliminated the corporate income tax, at the expense of middle- and low-income families. And it was an attempt to mitigate the economic distortions produced by the 1981 corporate tax breaks.

Such a backlash was surely needed. The 1982 act, despite some shortcomings, is an excellent piece of legislation. But the combination of the 1981 and 1982 bills still leaves the tax system less fair, more damaging to economic growth, and less capable of

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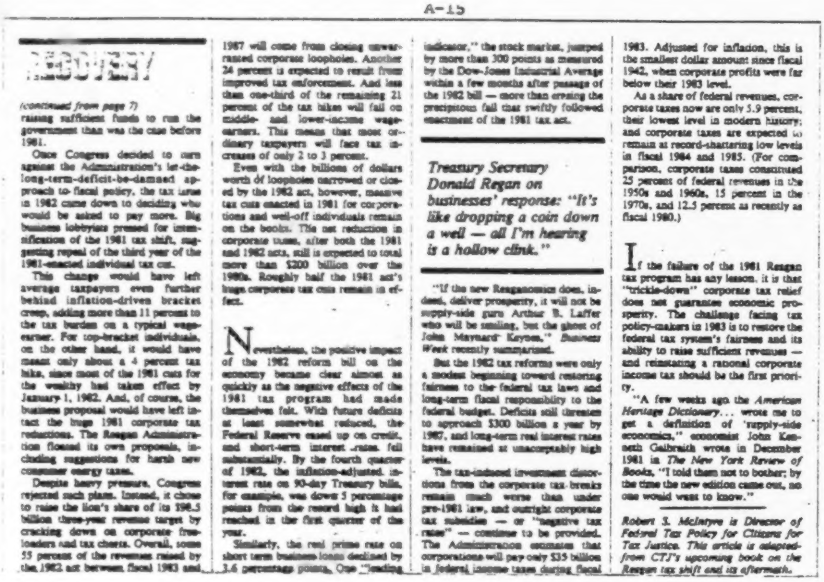

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raising sufficient funds to run the government than was the case before 1981.

Once Congress decided to turn against the Administration's let-the-long-term-deficit-be-damned approach to fiscal policy, the tax issue in 1982 came down to deciding who would be asked to pay more. Big business lobbyists pressed for intensification of the 1981 tax shift, suggesting repeal of the third year of the 1981-enacted individual tax cut.

This change would have left average taxpayers even further behind inflation-driven bracket creep, adding more than 11 percent to the tax burden on a typical wage-earner. For top-bracket individuals, on the other hand, it would have meant only about a 4 percent tax hike, since most of the 1981 cuts for the wealthy had taken effect by January 1, 1982. And, of course, the business proposal would have left intact the huge 1981 corporate tax reductions. The Reagan Administration floated its own proposals, including suggestions for harsh new consumer energy taxes.

Despite heavy pressure, Congress rejected such plans. Instead, it chose to raise the lion's share of its $98.5 billion three-year revenue target by cracking down on corporate freeloaders and tax cheats. Overall, some 55 percent of the revenues raised by the 1982 act between fiscal 1983 and 1987 will come from closing unwarranted corporate loopholes. Another 24 percent is expected to result from improved tax enforcement. And less than one-third of the remaining 21 percent of the tax hikes will fall on middle- and lower-income wage-earners. This means that most ordinary taxpayers will face tax increases of only 2 to 3 percent.

Even with the billions of dollars worth of loopholes narrowed or closed by the 1982 act, however, massive tax cuts enacted in 1981 for corporations and well-off individuals remain on the books. The net reduction in corporate taxes, after both the 1981 and 1982 acts, still is expected to total more than $200 billion over the 1980s. Roughly half the 1981 act's huge corporate tax cuts remain in effect.

Nevertheless, the positive impact of the 1982 reform bill on the economy became clear almost as quickly as the negative effects of the 1981 tax program had made themselves felt. With future deficits at least somewhat reduced, the Federal Reserve eased up on credit, and short-term interest rates fell substantially. By the fourth quarter of 1982, the inflation-adjusted interest rate on 90-day Treasury bills, for example, was down 5 percentage points from the record high it had reached in the first quarter of the year.

Similarly, the real prime rate on short term business loans declined by 3.6 percentage points. One "leading indicator," the stock market, jumped by more than 300 points as measured by the Dow-Jones Industrial Average within a few months after passage of the 1982 bill — more than erasing the precipitous fall that swiftly followed enactment of the 1981 tax act.

Treasury Secretary Donald Regan on businesses' response: "It's like dropping a coin down a well — all I'm hearing is a hollow clink."

"If the new Reaganomics does, indeed, deliver prosperity, it will not be supply-side guru Arthur B. Laffer who will be smiling, but the ghost of John Maynard Keynes," *Business Week* recently summarized.

But the 1982 tax reforms were only a modest beginning toward restoring fairness to the federal tax laws and long-term fiscal responsibility to the federal budget. Deficits still threaten to approach $300 billion a year by 1987, and long-term real interest rates have remained at unacceptably high levels.

The tax-induced investment distortions from the corporate tax breaks remain much worse than under pre-1981 law, and outright corporate tax subsidies — or "negative tax rates" — continue to be provided. The Administration estimates that corporations will pay only $35 billion in federal income taxes during fiscal 1983. Adjusted for inflation, this is the smallest dollar amount since fiscal 1942, when corporate profits were far below their 1983 level.

As a share of federal revenues, corporate taxes now are only 5.9 percent, their lowest level in modern history; and corporate taxes are expected to remain at record-shattering low levels in fiscal 1984 and 1985. (For comparison, corporate taxes constituted 25 percent of federal revenues in the 1950s and 1960s, 15 percent in the 1970s, and 12.5 percent as recently as fiscal 1980.)

If the failure of the 1981 Reagan tax program has any lesson, it is that "trickle-down" corporate tax relief does not guarantee economic prosperity. The challenge facing tax policy-makers in 1983 is to restore the federal tax system's fairness and its ability to raise sufficient revenues — and reinstating a rational corporate income tax should be the first priority.

"A few weeks ago the *American Heritage Dictionary*... wrote me to get a definition of 'supply-side economics,'" economist John Kenneth Galbraith wrote in December 1981 in *The New York Review of Books*. "I told them not to bother; by the time the new edition came out, no one would want to know."

Robert S. McIntyre is Director of Federal Tax Policy for Citizens for Tax Justice. This article is adapted from CTJ's upcoming book on the Reagan tax shift and its aftermath.

Mr. Downey. Thank you very much.

Mr. Motley.

STATEMENT OF JOHN J. MOTLEY III, DEPUTY DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Motley. Thank you, Mr. Chairman.

It is a pleasure to be able to appear and testify on behalf of the 560 members of NFIB, and I would like to submit my formal testimony for the record and summarize it.

Mr. Downey. Without objection.

Mr. Motley. Our economic report on small business indicates that smaller firms are terribly optimistic about the future and they are just starting to participate in the recovery that is out there. Unfortunately, the small firms depend on capital for debt financing. We believe a tax increase in 1984 will have a very bad effect upon this need for increased capital so that they can purchase new inventories, plant and equipment and also go out and hire the people they will need to come back in full steam into the recovery.

We also believe that a tax increase in 1984 will again create some uncertainty out there. If there is one thing that business people in general need right now it is to be somewhat certain of where the Government is going as far as taxes. So we would very much oppose a tax increase in 1984.

You might be interested in knowing that we are polling our membership on the administration's proposal for contingency tax increases in 1985 and 1986. Of the first 10,000 responses we have received to that poll, 89 percent of those responding have indicated that they would oppose such contingency tax increases. Small businesses are certainly interest rate sensitive and we fear the size of the deficit and the impact it will have on crowding out small borrowers in the marketplace but we also believe that that deficit must be brought down through spending cuts rather than through further tax increases.

The 1983 budget resolution called for $3 in spending cuts to every dollar in tax increases and so far from our membership standpoint they see they received TEFRA but they don't know where they received the $3 in spending cuts.

I believe revenues are running about 19 percent of GNP now which is somewhat below historical levels but not far below, where Federal spending is running between 24 and 25 percent of GNP which is considerably above historical peacetime levels.

Also I would like to say that within the last year the small business community has felt three rather regressive and significant tax increases, in TEFRA, unemployment compensation taxes were increased significantly, the gasoline tax in the beginning of this year went into effect in July, and also the social security tax increases.

All of these are terribly regressive. They are not related to the profitability of the firm. Two of them are outright taxes on labor and have a tremendous impact upon labor-intensive smaller firms.

Two other points I would like to make. There is a great deal of discussion of a surtax. NFIB believes that a surtax falls particularly hard on this same group of firms because we believe they pay particularly high effective tax rates now. They would prefer almost any other method of raising taxes other than payroll taxes or surtax.

Lastly, I would like to comment briefly on the chairman's proposal for a freeze simply to say I would agree with Dr. Rahn's comments and with what Mr. Fitch said here, that that particular proposal we believe would impact heavily upon smaller firms.

Thank you, Mr. Chairman, and I would be glad to answer any questions.

[The statement of Mr. Motley follows:]

STATEMENT OF JOHN J. MOTLEY III, DEPUTY DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman: On behalf of the 560,000 members of the National Federation of Independent Business, I appreciate the opportunity to comment on revenue increase proposals for the fiscal 1984 budget.

As a prerequisite to considering whether revenues need to be raised for fiscal year 1984, this committee should carefully consider the current state of our economy and trends as they are currently seen for the future. NFIB surveys its members every quarter in an attempt both to understand where they stand economically and to pinpoint their current problems. Based on the responses received, it seems that small business has become optimistic, in fact very optimistic, about future business conditions. This newly found optimism is also being rapidly translated into new plans for expanded sales and earnings.

It is not surprising, then, that the membership recently voted to oppose any tax increases in 1984. In a subsequent poll, they appear to be opposed to any tax increases for 1985 and 1986 as well, although results on this poll are preliminary.

STATE OF THE SMALL BUSINESS ECONOMY

Timing is a most difficult variable in determining which fiscal policy actions are appropriate. Countercyclical policies applied at the wrong time in the cycle of economic recovery are severely damaging. The fragile nature of our current economic situation requires that very careful consideration be given before action is taken, and how the actions might impact on the small business economy should be considered. Given that most new jobs are created by small business, special consideration for small business is warranted.

The April QER revealed that sixty-eight percent of the firms surveyed expected business conditions to get better or much better. Historically, the optimism index has proven an accurate tracker of Gross National Product (GNP) trends, and right now the index points up. Fueling this optimism was a strong resurgence in sales and earnings in the first quarter of 1983. Both of these factors were assisted by stable prices and conditioned reductions in the cost of credit. Planned inventory purchases are also increasing, meaning inventory turnover rates are up as well.

Given the fact that small business is beginning to recover from last year's economic doldrums, it is also significant that the April Quarterly Economic Report (QER) reflects their second most important concern is now taxes. These results reflect the opinion that at this point in a recovery, small business begins to see daylight and begins to think in terms of growth, expansion, and reinvested profits. Given the fact that a major portion of small business growth capital is internally generated through growth and debt, not venture capital, an anti-tax increase bias is strongly justified. Additionally, small business owners realize that substantial increases in payroll taxes were recently passed by Congress—tax increases which are already having their effect by holding down new employment in small business.

TAX INCREASES

To state the mood of the membership plainly, they are opposed to any form of tax or revenue increases in 1984, and if preliminary polling results hold, are opposed to tax increases for 1985 and 1986. They are opposed to new income taxes, surtaxes, revenue enhancers, contingency taxes, compliance measures, cash management changes, freeze proposals, or any proposal which will take money from the private sector and placed it in the public sector.

Specific mention needs to be made of the President's proposal for a contingency surtax, and of any surtax which might be placed on business and individual taxes. A surtax is the most discriminatory way in which to raise taxes, because it falls disproportionately on those who pay the highest effective tax rates without taking account of those with low tax rates. Tax benefits such as foreign tax credits, investment tax credits and accelerated depreciation are responsible for a sizable number of companies paying low tax rates.

NFIB strongly concurs with the Coalition to Reduce High Effective Tax Rates that a surtax would be a severe burden for small business, and would in general be an unfair tax burden placed on those already carrying too high a share of the tax burden.

Another proposal has been made which would freeze all tax reductions scheduled to take place after January 31, 1983, including indexing individual tax rates, phasing-in the estate tax exemptions, and the exclusion of interest income. Each of these proposals represents necessary and significant tax simplifications, reductions, and incentives, all of which greatly assist small business growth and productivity. Specifically, the estate tax exemption increases are most important to small business owners, as high estate taxes endanger the continuation of family owned businesses after the owner's demise. NFIB members consider the federal estate tax to be a highly regressive, overly complex and counterproductive tax policy designed to inhibit, rather than foster capital formation.

OPTIONS TO REVENUE INCREASES

The membership of NFIB is as concerned as anyone else over the size of projected budget deficits. However, tax increases are not the approach we would take at this time. The Tax Equity and Fiscal Responsibility Act of 1982 promised $3 of budget cuts for each dollar of tax increase. The tax writing committees complied with their tax increase targets, but the rest of Congress failed to curtail spending to the extent required by the reconciliation instructions. While many oppose further spending cuts, we feel there is much more room in which to operate.

CONCLUSION

If Congress wishes to take action to reduce the burgeoning budget deficit, action on further spending reductions needs to be taken by Congress. Consider that in 1983, Congress enacted three major pieces of tax legislation: the gasoline tax; the massive increases in payroll taxes from the social security restructing legislation; and the many provisions of TEFRA which became effective in 1983 Small business has seen its share of tax increases in 1983, and therefore feels very strongly that we need to refrain from passing any new tax increases for 1984.

Mr. Downey. Thank you.
Mr. Tremblay.

STATEMENT OF WILFRED J. TREMBLAY, CHAIRMAN, THE TAX COUNCIL AND VICE PRESIDENT FOR TAXES, HANNA MINING CO.

Mr. Tremblay. Thank you, Mr. Chairman.

I am Wilfred J. Tremblay, vice president for taxes of the Hanna Mining Co. and chairman of the Tax Council, on whose behalf I speak to you today.

The Tax Council is a business organization dedicated to active improvement of Federal tax and fiscal policy to accommodate and encourage real economic growth, higher productivity, and greater employment. Our membership is drawn from the entire spectrum of corporate enterprise. The industries now represented in the council include: heavy and light manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, public accounting, banking and all other forms of financial service. We welcome this opportunity to share our thoughts on the timing, the form and the size of tax legislation the committee may consider.

We are pleased that this committee questions the pattern of specific revenue increases contained in the first budget resolution for fiscal year 1984. It is evident in all the major budget proposals set forth over the last 6 months that the administration and both Houses of Congress believe that the level of revenues estimated for fiscal year 1986 is about $50 billion less than the level deemed adequate for the proper functioning of Federal activities, and we recognize that Federal policymakers are moving toward a major tax increase in fiscal year 1986.

The Tax Council, however, does not believe it is appropriate to enact legislation in 1983 that increases tax burdens. Instead, we continue to encourage aggressive review of Federal spending programs, especially in light of the findings of the President's Private Sector Initiative Survey on Cost Control. The tax structure is already straining under the demands to produce new revenues. Legislation that imposes new tax penalties on the accumulation and preservation of capital weakens the economic forces necessary for economic growth, increased employment and higher productivity of the work force.

The Economic Recovery Tax Act of 1981 made dramatic improvements in our system for cost recovery, individual retirement accounts, marginal tax rates, recognition of inflation, estate and gift taxes. Its principal objectives, to create incentives for economic growth and curtail tax penalties on savings and investment, were largely achieved. ERTA created an internally more stable, more capital-conscious Federal tax policy than has existed since the 1954 code was compiled.

TEFRA, with a fixed dollar gain as its overriding goal, took a disturbing step backward from the achievements of ERTA. The depreciation system, enacted just 1 year earlier and designed to phase in over many years, was stopped cold by the elimination of planned increases in the percentage used on the declining balance accounting method. Several points are worth recounting about the development of this depreciation system. First, the phase-in was deliberate to make room in the early years for the individual marginal rate cuts and to allow for the natural lead time associated with capital formation. Second, the depreciation system applies to new investment only and widely cited reports of negative tax rates apply to a small proportion of new capital employed in some industries. Industrial capital formation still has much catching up to do after years of inflationary erosion.

TEFRA also imposed a basis adjustment on the cost of capital equal to one-half of the investment tax credit. In 1962, when the investment tax credit was first designed, a basis adjustment was added but was repealed 2 years later in the Revenue Act of 1964. The reason cited then, that "this basis adjustment for property severely restricted the incentive effect of the investment credit," is still valid today, especially when considered in the context of the recession which has plagued our economy since 1979.

Mr. Chairman, as you consider the content of a new tax bill, we urge you to correct past legislation discouraging the formation of capital, and we encourage the committee not to continue this pattern. Unfortunately, many of the proposals currently before this committee are likewise flawed. The tax options offered to reach the budget targets in fiscal years 1984 and 1985 are, as in TEFRA, targeted against capital formation. Various CBO promoted tax expenditures, including a full-basis adjustment, repeal of percentage depletion for oil and gas, further erosion of ACRS with respect to buildings, repeal of intangible drilling costs and holding the estate and gift credit at the 1983 level, sacrifice well-designed, capital-conscious tax provisions for short-term revenue gain.

The cost in terms of lost real growth makes such suggestions very expensive. We are more concerned with the quality of the Federal tax system than with its ability to generate additional tax revenue. We would much rather see this committee deliberate slowly and with care, focused on a coherent and balanced Federal tax structure as well as on the anticipated revenue needs for the fiscal year beginning October 1, 1985.

In the spirit of this debate, we would like to suggest some basic elements that should characterize any major tax restructuring that may be considered. Taxes should be generated from the same source that produces what we call income, consumption, savings and investment—that is, from the stream of production that makes up our economy. The tax base should have as few exclusions or exemptions as possible, for reasons of both administration and equity, so that one low, flat rate would be sufficient. Overall, the imposition of a very broadly based transactions tax can only be of real advantage if it substitutes for other taxes. If the tax serves only to expand the size of government without the objectives of simplifying the Tax Code, reducing marginal rates on corporate and individual income and reducing the tax penalties on capital formation, then nothing is gained in the overall quality of the Federal tax system.

It is the opportunity to make the individual income tax structure, the corporate income tax structure, the payroll tax and the myriad excise taxes more efficient in achieving their multiple social and economic goals that makes a very broad based, flat rate tax appealing. Proposals to reach the mandated sum by a surtax and/or oil excise tax do not provide any such opportunity and in fact place the heaviest burden on those people and industries already paying substantial taxes.

Moreover, we feel there is a need for national attention to and debate about the content and form of tax legislation. Without addressing the merits of withholding on dividends and interest, and noting that the council has long supported increased financial and manpower needs of the IRS to better compliance, there is a lesson worth recognizing that arose in connection with withholding legislation. While the relatively low compliance rate on this type of income is known and understood by the policymakers here in Washington, the case was not successfully made to the American public. Once the provision was enacted into law, the opportunity for fair and reasoned debate was, for the most part, lost.

We cite this need for national attention and debate for good reason. Our tax system relies on self-assessment, and it seems to us greater cooperation and participation can be expected if taxpayers are involved in the development of tax policy as well as in the payment of liability. The opportunity for this involvement will be optimal over the next 18 months as we approach the 1984 congressional and Presidential elections. The groundwork has been laid with nationwide awareness of the disparity between Federal revenues and Federal spending. The prominence of the issue seems inevitable, and the education, both of and from the people, would be invaluable.

Mr. Chairman, the Tax Council does not believe it is appropriate to enact legislation in 1983 in order to increase revenues, especially in a piecemeal fashion that weights revenue gain over merit. We believe that raising the level of taxation and choosing the best method are worthy issues for national debate. Finally, if a tax increase is in the offing, the opportunity to make the entire Federal system more stable, more capital conscious and more balanced should not be lost.

Mr. HANCE [presiding]. Thank you.

Mr. Downey?

Mr. DOWNEY. Before I go, Mr. Motley, are members of the NFIB at all concerned about the Federal deficits?

Mr. MOTLEY. They are tremendously concerned about the Federal deficits, Mr. Chairman. They seem to be very, very angry about the prospects of new tax increases when the Federal Government is spending money at record levels.

Mr. DOWNEY. Because I would add that as a member of the Budget Committee, the President's deficit was still $190 billion if we adopted all his spending cuts.

So it seems to me that we have an enormous problem here that we have just got to face at some point regardless of the spending. No one wants to see it cut, but there are realistic amounts that we can save. We won't save more in social security and there are limits in the health care area. We will just have to face—as your members will have to—the fact we have to bring deficits down at the same time we reduce spending.

Mr. MOTLEY. I think they would, Congressman, except for the fact they look at the trendline and the trend in Federal spending is up. I don't believe they would support the amount of defense spending the administration would want in line with those arguments.

Mr. DOWNEY. Thank you, Mr. Motley.

Mr. RUSSO. I want to ask one question.

Mr. HANCE. Mr. Russo.

Mr. RUSSO. When you ask questions of your membership, depending on how you structure the question, you can solicit the answer you want. Did you compare the Democratic tax proposal of 1981 to the Reagan tax proposal and ask your membership how they felt about it?

Mr. MOTLEY. We did not do a poll comparing the two complete proposals, Congressman Russo. What we did do was prior to that we took a series of, I believe—and I can give you not only the polling information but the results, and the way it was asked—we took 12 to 15 of the most frequently mentioned ways to reduce taxes and we asked the membership to rate those as to importance to them. It was rather shocking to me individually, and I lost some money to Mike on it, that multiyear individual tax cuts came out first in that.

Mr. RUSSO. I would like to see that question because I authored seven amendments to the Democratic tax version which were, by the standards of every small business organization, except yours, highly supportable. In fact those specific seven amendments were put into the bill as a result of the White House Conference on Small Business.

I have a tough time sometimes understanding whether your organization actually supports small business per se as much as you support some Republican theory. Irrespective of what they propose you seem willing to support it.

I am on this committee as a result of my legislative background involving small business. I fought hard for small business. When you give someone outright expensing in the first year you are helping small business. When you reduce the corporate rate on the level we were talking about, you are helping small business. These are the two key items asked for by small business in the White House Conference.

But your organization supported ACRS which gives a mere pittance to small business and one of the reasons they can't get capital is because of the great advantages we gave to large corporations through tax cuts that small business can't use.

So I wonder, if you couched your poll properly, perhaps you would discover that small businessmen would react differently to your questions.

Mr. MOTLEY. We would be happy to provide everything of that sort to you. Remembering back to the 1981 debate, expensing was phased in over a number of years and was rather complex. Those people on the Ways and Means Committee staff who we discussed it with knew our position as to phase in and not to expensing itself.

As to corporate rates, as I remember it didn't cut them at the bottom but raised the cap and cut it in the middle.

Mr. RUSSO. What it did in the first couple of years is lower the brackets as well as cut the rates. We have several options there, which was one of the key things they asked for in the White House Conference.

I mention this because I have difficulty believing in polls when I know some of the things that I have tried to do for small business; your organization seems to occupy a position opposite to what I am trying to accomplish. I don't question your intent, but the phrasing I do question as to whether you are accurately identifying small business problems.

The reason small business cannot get capital is that so much money was thrown away, there is no money you can give to small businesses to overcome their problems. Right now, all the administration is concerned about is bailing out some big banks with $8.4 billion. You have small businesses going bankrupt and they cannot get help. Why? Because this administration's priorities are skewed.

I have to go vote.

Mr. HANCE. One question that I have, Mr. McIntyre. We are in the process of going over the revenue increase proposals. Has your organization taken any position on spending cuts. Should there be additional spending cuts, or have you addressed that problem?

Mr. McINTYRE. We have not.

Mr. HANCE. You have not addressed it at all.

Mr. McINTYRE. Our organization is a coalition of groups, and what we do for those groups is deal with tax policy issues. I have personal views, but they have nothing to do with my organization.

Mr. HANCE. I asked the last panel a question I would like to submit to this panel having to do with the possibility of a 3-percent decrease in the automatic COLA's on entitlement programs, and as a trade-off a 3-percent decrease in the tax indexing adjustments that are scheduled to go into effect in 1985.

I would like for all four of you to comment on that. If your organization doesn't have a position just try to tell me what you think that position would be if they did take one.

Mr. Tremblay.

Mr. TREMBLAY. The Tax Council does not have a position with respect to indexing as such.

My personal view would be that if there is anything we can do to preserve the integrity of the indexing, it ought to be done.

Mr. HANCE. Preserve the integrity of the indexing.

Mr. TREMBLAY. As we have it, yes.

Mr. HANCE. On spending as well?

Mr. TREMBLAY. That is correct.

Mr. HANCE. Mr. McIntyre?

Mr. McINTYRE. One of our members has testified here, the AFL-CIO. In answer to your question as to what our members would say, I have not polled them. I expect the majority view might be similar to the AFL's position.

Mr. HANCE. Their position was that——

Mr. McINTYRE. That the spending cuts already mandated in the budget are more than sufficient and that they would not support cuts in the COLA's.

Mr. HANCE They testified, I think, that not only the spending cuts in the current budget and those that have taken place since 1979, 1980, and 1981 have been too great, even though spending has gone up tremendously.

Mr. Fitch.

Mr. FITCH. Congressman, our position is that we support indexing on the tax side as a means to make one whole against bracket creep and inflation, the concept of a 3-percent-below-CPI trigger for indexing on the cost-of-living adjustment for spending programs is one that we find very intriguing and has a lot of potential.

We would out of equity support the same concept on the tax side as well. In fact, we strongly supported in the Social Security Reform Act the provision that provided for the indexing of benefit increases against CPI or wages. We believe that was a beginning toward examining the cost of living and spending issues that really needs attention.

So we could potentially find that position very interesting to support.

Mr. HANCE. The preference of your members would be to cut spending but if it took the other proposals to trade off to accomplish it, you think they would go for that?

Mr. FITCH. Yes, sir.

Mr. HANCE. Mr. Motley.

Mr. MOTLEY. Mr. Hance, we do not have a position on that type of proposal. I would find it very difficult to believe that most business people would consider 100 percent of CPI a good indexing formula for anything. It is certainly something that has intrigued us since we heard of it a couple weeks ago. We intend to look closely at it.

Mr. HANCE. Of course, you know we are looking at September before we are really able to do anything. Do you think there is a possibility that you may be able to poll your members on that issue between now and then?

Mr. MOTLEY. Well, I don't know if we have gone to press with the one going out in the field right now. If we have not, there is a possibility and the results would be back in September. If not, it would have to wait until the next one which is next month and the results would not be back until October at least, probably latter part of October.

Mr. HANCE. I think it would be very interesting to see how your members feel on that. I know——

Mr. MOTLEY. I will take the request back.

Mr. HANCE [continuing]. Most of the members get that analysis back, and it gives them information on what their district, State, and the Nation are thinking. I find those interesting to look at.

Whether I agree or disagree with them, it is always good to see them.

Mr. MOTLEY. Can I make one point as a comment that Mr. Russo made, and that is that NFIB will be more than happy to provide for the committee the polling results on all the various different parts of the tax cut in 1981 that you were involved in, and I would like to see the small business support or grassroots support for the different types of amendments that Mr. Russo offered to that tax cut, also.

He was comparing the two proposals. I think we might have tens of thousands of responses across the country and I am not sure that the proposal he made was put out to the public.

Mr. HANCE. One question, Mr. McIntyre. Chairman Rostenkowski made a speech some time ago about freezing all the pending tax reductions that had not gone into effect. Would you all support that?

Mr. McINTYRE. We think the freeze proposal is a very interesting one and particularly we believe that whatever happens on indexing—it will be very controversial obviously—that the other items on the list are very much worth doing on their own, just as good tax policy.

Mr. HANCE. What if there were a proposal to freeze all tax cuts passed in the 1981 tax bill that have not yet gone into effect and that if for 3 years, for example, and at the same time postpone all increases in spending for 3 years or even just 2 years?

Mr. McINTYRE. I am sure most of my members would be opposed to that.

Mr. HANCE. Because of the spending?

Mr. McINTYRE. The difference is there would be $10 billion in the tax freeze and $100 billion in spending cuts.

Mr. MOTLEY. My members would think it would be great.

Mr. FITCH. I am not sure how we would come out on it. If we felt the spending reductions as a result of that position were significant and really went to the bottom line, that is, the deficit. I would presume our members would take as a trade off for that the 2-year delay. They would not support a repeal.

Mr. HANCE. No, not repeal, just postponement. Mr. Motley, do you think your members would go along with that knowing that the Small Business Administration would be frozen for the same period of time?

Mr. MOTLEY. Mr. Hance, back in the discussions of the 1983 budget resolution, NFIB recommended a 27-percent cut in Small Business Administration funding because we felt it would be impossible for us to ask for similar cuts in other places so I am sure they would support it.

Not only that, it is amazing to us that some of the programs that are over there that we feel utterly useless to small business and have so told the concerned committees, continue to operate not only at past levels but at increased spending levels.

Mr. HANCE. Mr. Tremblay.

Mr. TREMBLAY. As far as the Tax Council is concerned we have not considered the issue. It would be my personal view certainly that any freeze that you have of any kind while the economy is coming into a recovery ought to be taken very seriously not to jeopardize the recovery that we are now enjoying.

It is slow to develop—not all businesses are recovering well. Certainly the indication yesterday by Secretary Regan was that he was feeling more comfortable with the recovery and that perhaps taxes will be generated in greater quantities than had been anticipated. If that is the case, then perhaps there would be no need for a freeze in the view of Secretary Regan.

Mr. HANCE. Do you think that a freeze on the provisions in the 1981 tax bill, that have not gone into effect would hurt business?

Mr. TREMBLAY. I certainly would think so.

Mr. FITCH. Yes.

Mr. HANCE. Why?

Mr. **Tremblay**. Well, the benefits of the 1981 act have not had their effects. The recession has not done a great deal to give us the benefits that the 1981 act provided.

Mr. **Hance**. Have not because of the interest rates to fully use them?

Mr. **Tremblay**. Just poor economy and the recession that we have had.

Mr. **Hance**. The proposal would not freeze anything that has already gone into effect from the 1981 tax bill, but would only postpone what was scheduled to go into effect say in 1984 or later.

Mr. **Tremblay**. As we go into a better recovery and as profits increase the tax burden would increase accordingly and the full benefit of the 1981 act really would not be enjoyed as was intended.

Mr. **Hance**. What about the question I asked earlier about if a tax bill passes, to have some type of trigger that, say, if it is a tax bill to go into effect in 1986 or future years, have some trigger so that that would not go into effect unless some type of spending cuts were also taken?

Mr. **Tremblay**. The problem with any trigger mechanism into the future and particularly when you are talking about 1986, which is a long time away from today, is how difficult it is to predict where we are going to be in 1986. Therefore, I don't like the idea of having the dependency where tax benefits accrue only if certain things happen.

I think we need more certainty than that in our tax system.

Mr. **Hance**. You think it would be better just to have a tax increase bill go into effect in 1986 and not address spending?

Mr. **Tremblay**. I think spending is always important. We have to address it. It is a very important issue.

It must be controlled and reduced. We must reduce the rate of growth of spending.

I think that is something we ought to be entertaining and viewing every year.

Mr. **Hance**. Mr. McIntyre, I think I know your answer from prior answers.

Mr. **McIntyre**. In terms of making tax changes contingent, the tax changes we have recommended, we think make sense from an economic point of view, on their own merits. If you decide to go after tax shelters, it seems foolish to say we like tax shelters if Government spending is high, but we don't like them if it is low.

We say, let's get these things out of the Tax Code whatever you do on spending. Because they are hurting the economy.

Mr. **Hance**. If you were opposed to them you would be opposed to the trigger, too?

Mr. **McIntyre**. In the case of the tax increases we are talking about, a trigger would be inappropriate.

Mr. **Hance**. Mr. Fitch.

Mr. **Fitch**. We are opposed to contingency taxes generally from the standpoint articulated just a moment ago; they have severe impact on tax planning. However, if we assume your scenario that a tax bill does in fact happen we would much prefer the contingency tax as to the clear and present danger of a tax bill being enacted and taking effect in 1984 and 1985.

However, we would condition support of a contingency tax concurrent on spending cuts.

Mr. HANCE. Mr. Motley.

Mr. MOTLEY. I think, Mr. Hance, that you have to do an awful lot of fast talking down in Lubbock to convince our members that the trigger works. If you did——

Mr. HANCE. They would be afraid the tax increases would go into effect and the spending cuts would not?

Mr. MOTLEY. Unfortunately, the history is there for that.

Mr. HANCE. Let me ask you this: If a tax for the future was going to pass, along with what Mr. Fitch was saying, he would at least rather have an amendment on the bill that said the tax increases would not go into effect unless spending cuts were achieved.

I know your position is against any new taxes or any contingency taxes. Wouldn't that be better than nothing at all?

Mr. MOTLEY. It would be but unfortunately amendments like that are simply ways to be able to politically vote for a particular resolution or bill.

Mr. HANCE. And set aside the spending for later.

Mr. MOTLEY. We have the same thing before and whether that would be used to reduce the deficit or not. I am afraid the good will of the small business community is rather thin toward those proposals. It would take a lot of convincing to get them to support it.

Mr. HANCE. They just don't believe they would go into effect.

Mr. MOTLEY. They don't believe it.

Mr. HANCE. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel members. Many of you have been here before and have helped us on various things. Your testimony has always been very helpful and I am sure it will be helpful, in these matters we are considering now.

I think I would agree with those of you who are concerned with the reductions in spending, I just don't believe it is going to happen either. I do want to thank all of you for being here.

Thank you, Mr. Chairman.

Mr. HANCE. Thank you.

I appreciate your being here, gentlemen, and being with us. I apologize for lack of membership here but we have had a quorum call.

Mr. HANCE. I would call the next panel, Harry Pryde of the National Association of Home Builders; Dr. Jack Carlson, executive vice president and chief economist for the National Association of Realtors; and Mr. Thomas Schroyer, vice president, finance, for the Turco Development Co. of St. Louis, and also representing the National Association of Industrial and Office Parks.

We will hear from Mr. Pryde first since he is the first one listed on the panel.

STATEMENT OF HARRY PRYDE, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. PRYDE. Thank you, Mr. Chairman.

I am Harry Pryde, I am president of the National Association of Home Builders and also a builder/developer from Seattle. I am testifying on behalf of our 111,000 members.

Mr. Chairman, large Federal deficits and accompanying recent increases in long-term interest rates create some dark clouds on the economic horizon. The housing industry has been in the forefront of the current recovery. The economic recovery is, however, in imminent danger of collapsing. This was the consensus of the NHB Executive Committee at its summer meeting just last week.

Rising interest rates, soaring and uncontrollable Federal deficits, and great uncertainty over the Nation's monetary policy threatens to choke off the housing lead recovery. During the past 6 weeks mortgage interest rates have risen 1 full percentage point, pricing out of the market over 1 million potential housing buyers, interest rate increases have dramatically slowed sales and in some parts of the country have actually stopped, it has reduced subdivision traffic now and you have builders with a growing inventory of unsold units.

The current economic situation demands bold leadership. To sustain the current recovery, a healthy noninflationary situation, we support a bipartisan compromise on the following issues: One, the growth in entitlement programs must be scaled back; two, the real increase in defense spending must be contained at the 5-percent level mandated in the congressional budget; and three, appropriate tax increases that will not abort the recovery should be considered now.

It is absolutely essential that Congress take action now to reduce the Federal deficits, carefully fashioned tax increases as well as reforms and entitlements are needed to bring deficits down.

Tax increases of the magnitude under the act are necessary.

The committee should develop a revenue proposal which is new to various sectors of the economy. The burden of tax increases should not be placed on housing and real estate.

Tax increases directly affecting housing should be avoided because of the following reasons. Tax increases falling on housing would be counterproductive in terms of the current recovery. Housing has been the major engine of the recovery and economic growth. To increase taxes on housing would dampen the recovery. Also, the housing depression has created a housing shortage, especially for low income renters. This is at a time when Government housing programs have been eliminated.

Tax increases on housing would increase the housing shortage.

On the business side, the tax law discriminates against structures when compared with equipment. The recovery period is three times longer than for equipment. For individuals, the mortgage interest deduction and other incentives makes homeownership more affordable.

The value of housing tax incentives really to other incentives has been gradually eroded.

Those are the various reasons why we think increases should be avoided for the housing sector.

As to specific options and timing, the housing industry needs deficit reduction measures now. The administration's contingency tax has a great deal of appeal because it involves across-the-board revenue increases. Its timing should be accelerated to take effect in 1984 and 1985.

Entitlement reform should proceed concurrently perhaps along the line of the Danforth-Boren spending and tax freeze. Perhaps—the committee should eliminate deficits entirely by adopting the contingency tax and Rostenkowski tax freeze.

When you add the administration's contingency tax of $138 billion and the freeze totaling $129 billion that would amount to $267 billion and doing this would probably do more than anything else to lead to a continuous sustained recovery and reduce interest rates.

In conclusion, we urge the committee to take seriously the economic difficulties which the Federal deficit presents. We would like to work closely with this committee to develop deficit reduction measures which do not jeopardize the economic recovery. I want to thank you, Mr. Chairman, for the opportunity to testify and would be happy to answer any questions.

[The statement of Mr. Pryde follows:]

STATEMENT OF HARRY PRYDE, PRESIDENT, THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and members of the Committe: My name is Harry Pryde and I am president of the National Association of Home Builders [NAHB]. I am testifying on behalf of the more than 111,000 members of NAHB. NAHB is a trade association of the Nation's homebuilding industry.

NAHB appreciates the opportunity to present its views, along with other members of the real estate industry, on tax increases as mandated in the congressional budget resolution for fiscal year 1984.

Mr. Chairman, large federal deficits and the accompanying recent increases in long term interest rates create some very dark clouds on the economic horizon.

The housing industry has been in the forefront of the current economy. The economic recovery is, however, in imminent danger of collapsing. This is the consensus of NAHB's Executive Committee at its summer meeting last week.

Rising interest rates, soaring and uncontrollable Federal deficits, and great uncertainty over the Nation's monetary policy threaten to choke off the housing-led recovery.

During the past 6 weeks, mortgage interest rates have risen by a full percentage point, pricing out of the market over a million potential housing consumers. Interest rate increases have slowed home sales, reduced subdivision traffic and left builders with growing inventory of unsold units.

The current economic situation demands bold and creative political leadership.

To sustain the current economic recovery at a healthy non-inflationary pace, NAHB supports a bipartisan compromise on the following issues:

The growth in entitlement programs must be scaled back.

The real increase in defense spending must be contained at the 5-percent level mandated in the congressional budget.

Appropriate tax increase that will not abort the recovery should be considered now.

Developing a consensus on these issues will not be easy, but it is absolutely essential that Congress take action now to reduce the Federal deficit. Carefully fashioned tax increases, as well as reforms in entitleman programs, are needed to bring the Federal deficit down.

The committee should develop a revenue proposal which is neutral relative to various sectors of the economy. With housing being a major component of the economic recovery, the committee should seek to avoid tax increases directly affecting this sector of this economy. Such changes could further jeopardize the economic recovery.

For individuals, proposals to cap the mortgage interest deduction or other tax benefits for housing would have a chilling effect on the housing market. On the business side, tax increases affecting real estate would accentuate current biases against business investment in real estate. One measure which has received attention is a lengthening of the depreciation period on structures to 20 years. Currently, structures have a depreciation period which is three times longer than equipment. To increase the disparity to four times would be highly detrimental—pushing capital away from risky, but needed, investment in residential rental projects.

Because of the need to raise significant revenues, particularly in fiscal years 1985 and 1986, in a manner which is as broad based and neutral as possible, the administration's contingency tax idea has appeal. Its major drawback is that its contingencies make it highly unlikely that the taxes will go into effect, even if the proposal is enacted. It does provide a good starting point for further consideration.

The tax freeze idea is attractive in the sense that it raises significant revenues, without requiring changes in the law currently in effect. It would involve some very difficult changes in the law effective next year. Delay of indexing is a controversial change as well as a delay of scheduled extate tax reductions. In addition, delay of indexing may not produce the revenues initially anticipated with the inflation rate at its current level.

The option of broadening the tax base has appeal in some areas—such as taxpayer compliance and other items which must be reviewed this year. But revenues from these sources are not sufficient to affect the deficit in a significant way. And, base broadening opens the potential for further tax increases on real estate at a time when tax incentives directed toward housing—both owner occupied and apartment projects—have gradually been reduced relative to incentives for other types of investments. This is occurring when, for strong policy reasons, such investment is needed.

II. TIMING OF TAX INCREASES

The economic recovery, particularly the recovery in housing, is now in its early, formative stages.

The current housing recovery is fragile and shows signs of turning downward.

Some important indicators are:

Housing starts for June show a downward trend—falling 3 percent to 1.747 million from nearly 1.8 million in May.

Interest rates for mortgages have started an upward spiral. FHA and VA rates are currently at 12.5 percent. Conventional rates now average 13.5 to 14 percent for 30-year fixed mortgages. This is an increase of 100 basis points for FHA and VA over the past 2 months and 100 to 150 basis points for conventional over the past 2 months.

New unsold inventory is increasing. In May, 1983 inventory stood at 276,000 units or 5.1 months of inventory at May sales rates.

Construction unemployment still stands at 18.1 percent in June 1983, representing 988,000 people out of work. This, however, has dropped from a peak of 22.3 percent in October 1982.

Housing has been through a very severe housing depression when compared with past economic housing cycles. (Appendix I) In 1982, the housing industry operated at its lowest level of production since 1946. Starts in 1982 ended up at 1.07 million, about 46 percent below the peak of the previous cycle in 1978. New home sales were at their lowest level since the Census Bureau began its survey in 1963. Construction unemployment averaged 20 percent, the highest level since the Bureau of Labor Statistics began its monthly unemployment survey in the late 1940's. The housing industry (with the exception of some builders in Texas and other isolated areas) is very happy that 1982 has ended.

The data indicates that the housing recovery needs a period of relative certainty with regard to interest rates, taxes and monetary policy. A steady monetary policy which accommodates the economic recovery is needed. The appropriate fiscal policy would be to reduce Federal deficits through reductions in entitlement spending and defense growth and carefully formulated tax increases.

Tax increases of the magnitude contemplated under the Congressional Budget Act are necessary. However, it may be appropriate to concentrate the significant revenue increases in fiscal years 1985 and 1986. Large and growing deficits in these years must be reduced, while the early phases of the economic recovery should not be dampened with significant tax increases in 1984.

The important role which housing plays in the overall health of the economy should be considered. The current recovery has relied to a large extent upon housing as the engine for recovery. Revenue increases directly affecting housing should be avoided.

There is an enormous ripple effect associated with housing. A housing upturn has created jobs, improved consumer and investor confidence, and stimulated activity throughout the economy. NAHB estimates that each 100,000 new single-family homes provide 176,000 worker-years of employment to construct and generates 14.7 billion in total economic activity, (including the multiplier effect). When taking into account the financial, legal and other services involved in selling the units as well as the spinoff purchases of goods and services generated by the home sales, a substantial amount of additional employment and economic activity is created throughout the economy.

III. OPTIONS

The Administration's contingency tax proposal has been described in a statement by John E. Chapoton, Assistant Secretary of Tax Policy, before the House Budget Committee. He stated, "The contingency tax plan proposed by the President is designed to raise revenues—and consequently reduce the deficit—by about 1 percent of GNP, provided that Congress has adopted spending reduction proposals along the lines proposed by the Administration and that there is insufficient economic growth to keep the deficit below 2½ percent of GNP. The contingency tax plan would go into effect on October 1, 1985, if the economy is growing on July 1, and if the forecasted deficit for fiscal year 1986 exceeds 2½ percent of GNP."

"The contingency tax plan would have only two provisions, each raising about half the required revenue. The first provision would be an across-the-board tax on individuals and corporations equivalent to a 5 percent surcharge on taxes otherwise due. The other provision would be an excise tax on domestically produced and imported oil of $5 per barrel."

The qualifications associated with the tax plan mean that it will probably never go into effect as currently structured. The details of the plan—a tax on individuals and oil—are hard to assess, in terms of their economic effect. But, the major advantage of the plan is that it raises revenue in a very direct, across-the-board, fashion. Linked with agreements on spending, the plan could be a starting point as a temporary way to increase revenues. After 1986, the tax could be eliminated.

The tax freeze proposal should also be seriously considered. However, a delay of indexing as well as the estate tax reductions, will be difficult. The controversy surrounding these changes diminish the possibility of developing a consensus. But, the Committee may want to look at the tax freeze as a possible alternative to the Administration's contingency tax.

If the Committee chooses to broaden the tax base through a series of selected tax increase proposals, the changes should be neutral. The current bias, on the business side, against investment in housing should not be accentuated and tax incentives promoting home ownership should be retained. Sound housing policy requires capital investment in housing over the next future years. Otherwise, the mounting shortage of available housing units, especially rental units for lower income households, will increase.

Future demographic trends demonstrate the magnitude of the anticipated housing shortfall, which the recent severe depression has exacerbated. The Joint Center for Urban Studies at Harvard and MIT has projected household formations in the 1980s to be between 1.3 and 1.5 million annually.

The shortfall will be especially acute in the area of rental housing. It should be noted that the housing start numbers include both single and multi-family housing starts. Therefore, depression years with low housing starts affect not only single-family homes for sale but available rental housing. In the future, new rental construction is not anticipated to keep pace with the elimination of existing housing stock due to age and decay and the increased demand for rental housing. NAHB estimates that multifamily housing construction will average approximately 500,000 new starts over the next 10 years. The annual shortfall between supply and demand for rental units during recent years has been estimated at 75,000–100,000 units annually. These trends occur at a time when government-assisted housing construction has been virtually eliminated.

The anticipated housing shortage does not necessarily mean a return to the robust housing market of the late 1970's. The prospects of the return of higher interest rates has made new homebuilding a much more risky venture than in the past. Interest rates will not return to the levels which existed in the 1970s. This will moderate the demand for owner-occupied residences and increase pressures on rental housing.

From a policy perspective, this scenario mandates continuation of current housing tax incentives. Additional targeted incentives are needed. H.R. 2916, which Congressmen Anthony and Frenzel, along with over 60 other members of the House of Representatives have sponsored, is an important starting point towards providing a targeted incentive for savings directed towards housing.

At the individual level, existing incentives directed towards housing should be retained. Home ownership is a top national priority—promoting social and political stability as well as contributing to the economy. The mortgage interest deduction, the deduction of real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains up to $125,000 on the sale of a personal residence for those over 55 are important tax incentives for housing.

The mortgage interest deduction, coupled with the deduction of property tax, probably has a higher level of appeal to middle-class Americans than any other tax deduction. It makes the ownership of a home affordable for millions of Americans.

Take, for example, a married couple with two children filing a joint return. Using the tax rates effective July 1, 1983, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family qualify for a $70,000 house. Without the mortgage interest deduction, the same family could qualify for only a $53,000 home. With the average price of a new home in the $70,000 range, the mortgage interest deduction becomes an important element in permitting ownership of a home. The details of the example are provided in Appendix II.

While the mortgage interest deduction makes housing affordable, the view that it overly subsidizes housing at the expense of other investments, is incorrect. Double digit inflation, high marginal tax rates, and fixed rate mortgages at a level below the inflation rate produced a combination of factors which made housing a favored investment in the 1970s. High marginal tax rates, which placed many middle-income taxpayers in high tax brackets, made the mortgage interest deduction extremely valuable for most middle-income families. In these circumstances, housing, with a high loan-to-value ratio, become a popular investment.

But the economic circumstances which made owner-occupied housing attractive from an investment point of view have reversed. Inflation-induced increases in housing prices have moderated substantially.

In March, 1983, the median price of new homes sold was $75,900, up $6,600 from the median price of $69,300 a year earlier. The median price of new homes sold in 1982 was $69,300—only a .6 percent increase over 1981, when the median price averaged $68,900. Actual housing costs, however, were even lower than those registered by new home prices, because many builders bought down mortgages and used other methods of creative financing to sell off inventories. Prices over the past two years have been relatively flat when compared with prices during the inflationary 1970s. (Appendix III)

From a tax point of view, marginal rate reductions have decreased the value of the mortgage interest deduction, as well as other itemized deductions, as more and more taxpayers are dropped into lower marginal tax brackets. Increases in the standard deduction also have eroded the tax advantages associated with the mortgage interest deduction and housing investment.

Finally, incentives for alternative investments, particularly individual retirement accounts and other forms of savings, have helped to reorder priorities towards savings.

This shift is a direct result of tax changes which were put in place in 1981. As the Economic Report of the President for 1982 noted:

The sizable reductions in tax rates on capital income mean that real after tax returns on household savings will be substantially higher than they have been in the recent past. As a result, the implicit price of consumer durables has risen and a long run shift in demand away from housing, automobiles, and other consumer durables may result. (Page 126)

The movement in tax incentives away from housing is confirmed in a study dated October 25, 1982, by the Congressional Research Service. The study, "Tax Subsidies to Housing, 1953–83" indicates that tax subsidies for housing, both owner-occupied and rental investment housing, have declined over time as compared to tax subsidies for other types of assets. The study notes "the spread between the return on business assets and the return on owner-occupied housing has diminished and in some cases disappeared. One can no longer argue unambiguously that owner-occupied housing receives a tax subsidy relative to business capital." (Page 22)

NAHB views the direction of tax changes towards more savings and investment as a healthy and necessary change. The point is not that the changes should have been made, but only that the changes reduce the tax incentive associated with a home purchase compared to other types of investments. Tax increases affecting housing would be counterproductive for the entire economy.

Regarding rental housing, tax incentives, including ACRS depreciation, "at-risk" provisions, and recapture rules for rental housing are a major means of providing for investment in rental housing projects. Changes in the current tax rules would severely disadvantage investment in rental housing as opposed to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes (IRC Section 189) be capitalized was introduced in 1976. No other industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds.

The ACRS recovery allowance for structures, adopted in 1981, should not be revised to reduce current depreciation allowances.

From an investment point of view, rental housing has often not been attractive. Intensive management is necessary to both maintain rental housing and to assure a steady income stream. Cost of maintenance of rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, residential housing needs to retain current depreciation allowances to be competitive with other types of investments. A reduction in present depreciation allowances would only drive capital away from residential housing at a time when more, not less, capital is needed.

NAHB supported the 1981 ACRS depreciation changes because of their certainty and simplicity. It is, however, a misconception to believe that the changes, in terms of new residential construction, significantly increased depreciation write-offs. In fact, component depreciation plus the ability to use 200 percent declining balance often created a more advantageous depreciation situation for new housing than the situation after ACRS. The table in Appendix IV analyzes component depreciation and ACRS. As the table demonstrates, component depreciation provided larger total write-offs over six years than are allowed under ACRS. The tax savings as well as interest on the tax savings amounted to a substantial sum.

Possible changes in the current tax rules associated with depreciation allowances for structures would bring uncertainty into the market place again, thereby diminishing the potential for future economic growth in this important sector of the economy.

The ACRS changes benefitted other types of assets, particularly equipment, much more than real estate. The effective tax on structures, was relatively unchanged both before and after 1981. This result is confirmed in several places. First, the economic report of the President, 1982, comments: ". . . ACRS does not treat all types of business investments equally. Although favorable to all new investment, ACRS is relatively more favorable to investment in equipment. As a consequence, industries for which short-lived equipment represent a large fraction of their total capital will face lower effective tax rates than industries with a low equipment-intensive capital structure." (Page 124)

The relative bias of current tax rules toward equipment as opposed to apartment buildings is underscored in a Library of Congress study in 1981 entitled "Effects of the Accelerated Cost Recovery System by Asset Type." The study notes: ". . . there may well be a shift in the composition of capital towards business equipment and away from structures particularly away from residential structures. The relative (and perhaps absolute) size of the housing stock could fall, not only because of the effects on rental housing but also because high interst rates will make owner-occupied housing less attractive and because there are no offsetting tax benefits."

Therefore, as the Committee looks at base broadening approaches, the relatively heavy tax burden on rental housing should be considered. Rather than increasing the tax burden by changing ACRS, the Committee should look at other avenues for broadening the tax base.

Another aspect of the ACRS that has generated criticism is that used property is treated the same as new property; both are equally eligible for the 15-year ACRS write-off. However, the ACRS is available for used property only if the persons acquiring the property did not own it prior to 1981, the year the ACRS rules became effective. Thus, while sales of existing residential property are possible, these involve a new set of purchasers and free up the capital of the former owners that has been locked up in such property. This freeing up of capital is a positive rather than negative result since the capital can be channeled into new investment. Moreover, the Treasury benefits from the capital gains tax that must be paid as a result of the resyndication.

Concern has also been expressed that the ACRS may be used for property received in a tax-deferred exchange qualifying under IRC §1031. This situation, however, is covered by the comprehensive rules against "churning" provided in IRC §168(e)(4). These rules deny ACRS depreciation for property received in exchange for pre-1981 property in a tax-deferred exchange unless additional debt or cash is made part of the transaction. Even then, ACRS is available only to the extent of the new debt or cash.

Finally, in looking at broadening of the tax base, the idea of the flat tax rate or variations such as the Bradley/Gephardt proposal come to mind. NAHB urges that the implications of such a flat rate tax or other comprehensive changes be carefully considered. NAHB is now conducting a thorough study of the flat rate tax for presentation to its members at its next annual convention in January, 1984.

IV. CONCLUSION

In 1982, NAHB worked for the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) because of concerns about large federal deficits and high interest rates. Today, after a period of moderation in interest rates, many of the same concerns remain.

NAHB is disappointed that Congress has not made significant progress in curtailing entitlement programs. This must be addressed to provide a foundation for sustained economic recovery. The Congress should develop a bipartisan concensus on entitlement spending, defense spending, and revenue increases. A fiscal policy which reduces future federal deficits must be followed.

With the budget resolution mandating substantial tax increases, as this Committee looks at tax expenditures and at future tax legislation, it should keep in mind the implications of various tax proposals upon housing—both owner-occupied housing and rental units.

The recent housing depression has created a shortfall in available housing units, especially rental units for low and moderate income families. Changes in the tax code, which would increase the tax burden on housing, would inevitably heighten the housing shortfall.

The crucial role of housing as the engine of the present economic recovery also needs to be considered. Uncertainty about the future, particularly the tax future, has a dampening effect upon investment decisions. Discussion of dramatic changes in the tax law affecting housing would lead to a slower recovery.

Finally, it is a misconception to view housing as being favored under the tax code. The tax benefits for owner-occupied housing have diminished through changes in the economic environment and as tax incentives for other types of investment have increased. With regard to business assets, structures have a heavier tax burden than other types of assets. Changes in the depreciation life for structures would only increase this tax burden and drive investment away from needed rental housing.

We appreciate the opportunity to present our views concerning important tax issues. I would be pleased to answer any questions you may have.

APPENDIX I

BACKGROUND: CURRENT HOUSING PRODUCTION AND PAST CYCLES

A comparison with past housing cycles shows that the current downturn was much more severe than past recessions. The latest housing recession was the longest running and the most devastating of the seven the industry has suffered since World War II. Total housing starts for 1981 were 1,100,300—the lowest annual production since 1946. Starts in 1982 finished slightly below the 1981 level.

1983 is forecast as a recovery year. The housing recovery will be strongest in the Sunbelt and less convincing in other areas of the Northeast and Midwest, whose main-line industries have been especially hard hit by the recession.

The recovery will be significantly slower than those that preceded it because: (1) it will take time for suppliers of building materials to shift back to higher levels of production; (2) the general economy will not gain as quickly as housing, most likely leaving unemployment above 10 percent until mid-year; and (3) mortgage interest rates, while significantly lower than they were during the recession, will, because of structural changes in the savings industry, remain relatively high by historical standards.

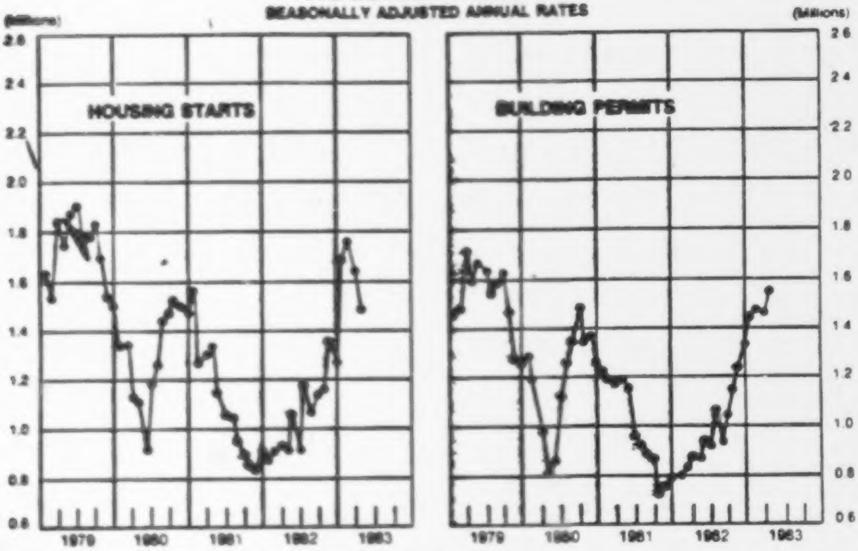
SEVEN HOUSING CYCLES SINCE WORLD WAR II

Period	No. of mo. between high and low	No. of housing starts (in thousands)			Percent change
		High	Low	Difference	
August 1950 to July 1951	11	1,889	1,154	735	−38.9
December 1954 to March 1957	27	1,703	1,068	635	−37.3
December 1958 to December 1960	24	1,604	1,041	563	−35.1
December 1965 to October 1966	10	1,656	843	813	−49.1
January 1969 to January 1970	12	1,769	1,108	661	−37.4
January 1973 to February 1975	25	2,481	904	1,577	−63.6
November 1978 to October 1981	36	2,107	854	1,253	−59.5

On a 10-year basis, between 1971 and 1981, total private and public housing starts ranged from a high of almost 2.4 million units in 1972 to a low of just over 1.1 million units in 1981. A new annual low for the period was set in 1982—1.07 million units.

Year:	*Price*
1971	$2,084,500
1972	2,378,500
1973	2,057,500
1974	1,352,500
1975	1,171,300
1976	1,547,600
1977	2,001,700
1978	2,036,100
1979	1,760,000
1980	1,312,600
1981	1,100,300
1982	1,072,000

APPENDIX I Con't



HOUSING TRENDS
SEASONALLY ADJUSTED ANNUAL RATES

SOURCE: Bureau of the Census, U.S. Department of Commerce, NAHB Economics Division

APPENDIX II

Mortgage Interest Deduction and Housing Affordability

Assume: Married couple filing joint return. $3,400 in deductions other than mortgage interest. Adjusted gross family income of $35,000 per year. Tax rates effective July 1, 1983.

Mortgage Interest Deduction	
Term	30 Years
Interest Rate	12 Percent
Price	$70,000
Downpayment	$7,000
Mortgage Amount	$63,000
P & I/Month	$648.00
P & I/Year	$7,776
Interest/Month	$629.00
Interest/Year	$7,548
Income -- Tax Savings	$1,922
Effective Annual P & I Payment	$5,854
Effective Monthly P & I Payment	$488.00
Effective Int. Rate	8.58 Percent

Real Estate Tax Deduction	
Property Taxes/Year	$1,260
Income Tax Savings	$277.00
Effective Property Tax/Year	$983.00

Total Tax Savings from Interest and Property Taxes/Year - $2,199

If one assumes principal, interest and property taxes, both deductions equal 30 percent of adjusted gross income, an income of $30,120 would be needed to qualify in the example above. Lenders calculate the interest and property tax savings into their 30 percent criterion. Hence, a family is paying only 22.7 percent of their income for principal, interest and property taxes. If there were no deduction and lenders used a 22.7 percent criterion, the family could afford a house costing only $53,000.

APPENDIX III

NEW HOME PRICES: 1972 to 1982

From 1972 to 1982, prices rose about 151 percent, from $27,600 to $69,300.

Year	Price	Year	Price
1972	27,600	1978	55,700
1973	32,500	1979	62,900
1974	35,900	1980	64,500
1975	39,300	1981	68,900
1976	44,200	1982	69,300
1977	48,800		

APPENDIX IV

COMPONENT DEPRECIATION VERSUS ACRS: NEW CONSTRUCTION

The following assumptions are made in the example:

1. The owner is in a 50% tax bracket.
2. The owner changes to straight line depreciation.
3. The building was completed and placed in service on January 1, 1983.
4. Interest computations on tax savings are computed at 20% (IRS rate for 1982) for the first tax year's savings; 16% (IRS rate for 1983) for second year's tax savings; and 12% for the remaining years.
5. Two hundred percent declining balance method is used on component depreciation.
6. The life of the different components are taken from real estate development companies.

The analysis shows substantial benefits under component depreciation prior to 1981 as compared to ACRS. Under component depreciation, at the end of six years, there would be a tax savings of $54,553. The interest that could have been earned on this tax savings over the six year period would be $80,590. Therefore, efforts to reduce current depreciation allowances for structures would continue the inequitable treatment of structures, as compared with other assets, which was created in 1981.

2/14/83

N A H B EXAMPLE
SIX YEAR COMPARISION
COMPONENT DEPRECIATION VS. A C R S

	COST	ESTIMATED LIFE	FIRST YEAR	SECOND YEAR	THIRD YEAR	FORTH YEAR	FIFTH YEAR	SIXTH YEAR	TOTAL
	COMPONENT METHOD PRIOR TO 1981 TAX LAW								
BASIC STRUCTURE	$672,076	$40	$33,604	$31,924	$30,327	$28,811	$27,371	$26,002	$178,039
----INTERNAL CONSTRUCTION----									
CEILINGS	108,012	30	7,204	6,724	6,275	5,857	5,466	5,102	36,628
WALLS	192,022	30	12,808	11,954	11,156	10,412	9,718	9,069	65,117
DOORS	72,008	10	14,402	11,521	9,217	7,374	5,897	4,719	53,130
FLOORS	108,012	30	7,204	6,724	6,275	5,857	5,466	5,102	36,628
----ELECTRICAL----									
WIRING	84,010	15	11,199	9,706	8,412	7,291	6,319	5,476	48,403
LAMPES & FIXTURES	72,008	8	18,002	13,502	10,126	7,595	5,696	5,696	60,617
----PLUMBING----									
BASIC	96,011	15	12,798	11,092	9,614	8,332	7,221	6,259	55,316
FIXTURES	,108,012	15	14,398	12,479	10,815	9,374	8,124	7,041	62,231
EQUIPMENT	60,007	8	15,002	11,251	8,439	6,329	4,747	4,747	50,515
ROOF	60,007	10	12,001	9,601	7,681	6,145	4,916	3,933	44,277
AIR CONDITIONING	144,016	10	28,803	23,043	18,434	14,747	11,798	9,438	106,263
APPLIANCES	96,011	3	64,008	21,333	10,670				96,011
FLOOR COVERING	156,018	3	104,013	34,667	17,338				156,018
DRAPES & DECORATING	120,014	3	80,010	26,667	13,337				120,014
CABINETS	72,008	15	9,599	8,300	7,196	6,239	5,409	4,690	41,433
POOL	72,008	8	18,002	13,502	10,126	7,595	5,696	5,696	60,617
OUTSIDE FENCE	24,003	5	9,601	5,761	3,456	2,593	2,592		24,003
YARD IMPROVEMENTS	84,010	10	16,802	13,442	10,753	8,603	6,882	5,506	61,988
TOTAL	$2,400,273		$489,460	$283,193	$209,647	$143,154	$123,318	$108,476	$1,357,248
	A C R S METHOD ATER 1981 TAX LAW								
A C R S RATE (CCH TABLE 1165B)			12.00%	10.00%	9.00%	8.00%	7.00%	6.00%	
A C R S DEPRECIATION	$2,400,273	$15	$288,033	$240,027	$216,025	$192,022	$168,019	$144,016	$1,248,142
			COMPARISION						
DIFFERENCE BETWEEN COMPONENT & A C R S			$201,427	$43,166	$-6,378	$-48,868	$44,701	$-35,540	$109,106
ACCUMULATED NET DIFFERENCE			$201,427	$244,593	$238,215	$189,347	$144,646	$109,106	$109,106
TAX SAVINGS (50% TAX RATE)			$100,714	$21,583	$-3,189	$-24,434	$-22,351	$-17,770	$54,553
INTEREST ON TAX SAVINGS			$20,143	$19,568	$14,293	$11,361	$8,679	$6,546	$80,590

Mr. HANCE. Thank you for your summation.
Mr. Carlson.

STATEMENT OF JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS

Mr. CARLSON. I am Jack Carlson, executive vice president of the National Association of Realtors. On behalf of 575,000 members we would like to recommend a program to reduce Federal deficits we call "Three For All to Keep America Growing"; 3 percent slower growth in indexed Government spending and 3 percent lower adjustments in the 1985 scheduled indexation of tax brackets.

Some progress has been made in slowing the spending growth in defense and domestic programs; however, much more needs to be done regarding these and other Federal spending programs. Clearly, progress must be made to slow the spending growth of Federal entitlement programs, primarily the non-means-tested Federal programs where the spending benefits are automatically indexed with increases in the Consumer Price Index.

The first part of the "Three for All" program would urge 3 percent slower growth in entitlement spending for years 1985 to 1989. Past automatic spending increases have overstated inflation and exceeded the intent of Congress because of the defective measure of the loss of purchasing power through the use of the Consumer Price Index. Although an improvement recently has been made in calculating CPI so that overstatement will be less in the future, the consistent overstatement in the past caused benefits to increase by more than 15 percent above the true loss of purchasing power.

Moreover, the continued reliance on the measure that does not reflect current purchases but instead relies on historical and fixed market basket of purchases, justifies accepting smaller benefit increases than indicated by the CPI increases. These deficiencies of the CPI are recognized and adjustments are made elsewhere in non-Government indexed programs in this country and with the governments of most other industrial countries. Now, the adjustment in CPI should be applied fairly to the U.S. Government as well.

About three-fifths of any increase in the CPI is used to increase pay among those U.S. workers under collective bargaining agreements. The 3-percent reduction in Federal cost-of-living adjustments tied to the Consumer Price Index approximates the practice in the private sector in the past and forecasts for 1985 through 1989.

To provide that many Americans will make a small sacrifice to reduce the deficit, we further recommend 3 percent less automatic personal income tax indexing starting in 1985. The deficiencies of the CPI justify dampening its impact on tax indexation as well as for indexed spending.

Over indexation of personal income tax brackets primarily stimulates over consumption instead of encouraging savings and investment. We are a savings and investment short economy, compared with the other major industrial countries. If Three For All were enacted the benefits for Americans would be obvious, while requiring only a small sacrifice, either through benefits or taxes, for most persons. The program would help to achieve a balanced budget at full employment within 5 years. It would help keep America growing and the economy recovering with much greater employment and less inflation; with higher family incomes and less poverty; greater opportunities and greater security for all Americans including the elderly; and more resources for national security and humanitarian concerns. It is necessary that savings and investment incentives be preserved as opposed to being sacrificed and that we provide greater investment in the skills of people, more adequate housing, better products and services and thus a higher standard of living and quality of life. Three for All is a step toward these goals.

The wisdom of this program is reflected in part in the legislation proposed by Republican Senator John Danforth and Democratic Senator David Boren in Senate bill 1627. Hopefully a similar bipartisan bill will be introduced in the House of Representatives and adopted by both the House and Senate and signed into law by the President this year.

Thank you.

[The statement of Mr. Carlson follows:]

STATEMENT OF DR. JACK CARLSON ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

I am Jack Carlson, Executive Vice President and Chief Economist of the National Association of Realtors.

On behalf of the 575,000 members of the National Association of Realtors, we appreciate ther opportunity to present our views on revenue proposals to reduce the federal budget deficits.

Our industry is very concerned with the current record federal budget deficit and those projected for 1984 and beyond. We are disappointed with the inability of Congress and the President to limit the size of the federal deficit. The First Concurrent Budget Resolution adopted by the Congress sets a spending growth target of 5.3 percent, more than the estimated rate of inflation. In spite of earlier promises to use his veto to slow down the growth of spending, the President signed, instead of vetoing, the HUD Appropriations bill which busted the budget by $6 billion (budget authority). Veto of all other excessive Appropriations bills is not likely to produce as large savings as veto of the HUD Appropriations bill alone. Thus spending continues to increase rapidly.

With runaway spending continuing and with Congress and the President having established in law automatic reductions in personal income taxes, the federal deficit will continue at record levels for the foreseeable future. Thus, the federal government will continue to siphon a significant proportion of the nation's savings for its use, thereby creating a shortage of investment funds needed by people for making improvements in their skills, housing, and physical capital, to provide better products and services for an overall increase in the American standard of living.

The crowding out of people's investments has caused real interest rates, those rates above the inflation rate, to stay at very high levels and in fact to increase, such as has occurred during the last two months. In additon, the government is fueling the fears that inflation will increase within a few years to double-digit rates because of persisting huge deficits when shortages appear in skilled labor and in housing, plants and equipment.

Both crowding out and inflationary expectations fueled by the government deficit threaten the durability of the current recovery with loss of jobs, family income, lower standard of living and quality of life. The frustrations of Americans and of people abroad as they fail to realize their expectations for jobs and income, will reflect adversely on those in charge, with the potential result of the American people electing Congressmen who will enact wiser economic policies.

BASIS FOR CHANGES IN TAX POLICY

As to the topic of this hearing, we recommend that any tax increases should be designed to:

(1) Continue the recovery;

(2) Be tied to at least a dollar-for-dollar cut in major spending programs;

(3) Be fair to all Americans;

(4) Encourage savings and investment in human and physical capital;

(5) Recognize that incentives to save and invest should be changed no more frequently than five years from previous chnges;

(6) Encourage balanced investment in housing and industry—currently the effective tax burden on apartment buildings is more than twice the burden on equipment;

(7) Encourage home ownership—current policies for the first time in our lifetime are causing a decline in home ownership, where one-half of the gain in the percentage of people owning homes in this country, compared with home ownership during the whole decade of the 1970's, has been wiped out during the last 3 years. This is despite the fact that home ownership provides an incentive for adequate housing and greater savings for both housing and other investment. It also is associated with more stable families, greater participation in decisionmaking in neighborhoods, volunteer organizations, cities, states and national government, including voting, and greater financial security for older Americans.

RECOMMENDATIONS

In order to achieve these objectives, we recommend a program that is summarized by the words: "Three for all to keep America growing."

Three percent slower growth in total government spending. Inasmuch as some progress has been made in slowing the growth in defense in the First Budget Resolution and modest progress has been made in some domestic discretionary programs, but no progress beyond 1983 has been made in dampening the growth of non-means tested programs where the funds are automatically increased with increases in the Consumer Price Index (CPI).

Three percent slower growth in entitlements than the increase in the CPI would adjust for some of the excessive growth of entitlements during the last several years. Past automatic increases have been excessive and exceeded the intent of Congress because of the defective measurement of the loss of purchasing power by use of the CPI. Although an improvement has been made in the design of the CPI so that over-statement will be less in the future, nonetheless the continued reliance on a measure that does not reflect the actual purchases made by people but rather relies on a fixed market-basket of purchases irrespective of price increases of some items, or no price increases of others, argues for dampening down any program increases based on raw increases in the CPI. Since the deficiencies of the CPI are recognized and adjustment is made elsewhere in our society, it is fully justified and fair that such changes should be recognized and implemented by the government. Only about three-fifths of any increase in the CPI is used to increase pay among those workers who are under collective bargaining agreements.

Three percent less automatic personal income tax cuts as measured by the CPI would link any necessary tax measure with similar spending slowdowns. Again the deficiencies of the CPI justify dampening its impact on tax cuts as well as on spending. The automatic tax cuts primarily stimulate consumption instead of savings and investment, which is most needed now and for the foreseeable future.

The wisdom of the three for all program is reflected in the legislation proposed by Republican Senator John Danforth and Democratic Senator David Boren, Senate Bill 1627. Hopefully, a similar bi-partisan bill will be introduced in the House of Representatives and adopted by both the House of Representatives and the Senate and signed into law by the President.

If three for all were enacted and in addition Congress froze growth of domestic spending and controlled defense spending growth and these bills became the law of the land, the benefits for Americans would be obvious:

(1) A small sacrifice for most Americans will have solved our federal deficit problem by 1988.

(2) We will have kept America growing and the economy recovering with much greater employment, significantly less inflation, significantly higher family incomes, less poverty, greater opportunities, greater security for older Americans, and more resources for national security and humanitarian concerns.

(3) Achieve a balanced budget at high employment within five years.

(4) Prove the government can live within its means.

(5) Assure that savings and investment incentives are not sacrificed by ill-advised tax increases on savings and investment.

(6) Provide greater investment in the skills of people, more adequate housing, better products and services, and thus a higher standard of living and quality of life for all Americans.

We are not saying the Danforth-Boren proposal is a total solution to the economic problems of this country—the President and Congress will still have to control domestic discretionary spending and defense spending. We do, however, believe the time has come for Congress to seriously consider adjustments, of the Danforth-Boren type, on both spending and taxation to bring deficits under control.

The balance of my statement concerns specific real estate taxation provisions.

BACKGROUND

As interest rates and threats to continued economic recovery mount, some may suggest altering the real estate savings and investment tax incentives. We believe any adverse investment incentive changes would be short-sighted, occur at precisely the wrong time and severely threaten economic recovery.

The housing industry, following its traditional role, has led the nation's economic recovery thus far. Residential investment increases at an annualized rate of 39.1 percent during the fourth quarter of 1982 and by 83.1 percent during the first quarter of this year.

The impact such investment has on the economy is detailed in the following tables and shows:

Each of the new homes built in 1982 resulted in over $91,000 in Gross National Product (GNP).

Each single-family resale which occurs in 1983 results in almost $11,000 of direct expenditures and over $5,000 of secondary expenditures. Together, each 1983 home resale contributes over $16,000 to GNP.

Total 1983 home resales of 2,700,000 will contribute over $43 billion to GNP and provide 850,000 full time jobs.

Construction of 1,100,000 new single-family homes in 1983 will contribute $96 billion to GNP and provide nearly 2 million full time jobs.

Maintenance, repair, and improvements by residential property owners in 1983 will generate $83 billion in GNP and will result in 1.7 million jobs. Nearly 45 percent of all homeowners are involved in home maintenance and repair projects.

Construction of 500,000 new multi-family residential units will contribute $35 billion of GNP and provide 710,000 full-time jobs.

Development of commercial and industrial structures in 1983 will contribute $77 billion to GNP and provide 1.5 million full-time jobs.

In 1983, total economic activity of the real estate industry will represent over 8 percent of 8 GNP and over 5 percent of total employment.

OUTPUT AND EMPLOYMENT OF THE REAL ESTATE INDUSTRY: 1983

[GNP; dollars in billions]

	Direct	Indirect	Total	Full-time jobs (thousands)
Single-family resales	$28.7	$14.3	$43.0	850
Single-family starts	64.0	32.0	96.0	1,920
Maintenance repairs and construction improvements	55.0	27.5	82.5	1,650
Multifamily starts	23.6	11.8	35.4	710
Commercial development	38.0	19.0	57.0	1,140
Industrial development	13.5	6.8	20.3	405
Other private construction	11.7	5.8	17.5	350
Total			[1] $351.7	[2] 7,025

[1] 10.7 percent of total GNP.

[2] 6.9 percent of total employment.

Source: National Association of Realtors.

GROSS NATIONAL PRODUCT GENERATED BY THE AVERAGE PRICED SINGLE-FAMILY RESALE AND THE CONSTRUCTION AND SALE OF THE AVERAGE-PRICED NEW SINGLE-FAMILY HOME: 1983

	Resale	New
Average selling price	$80,700	$87,100
Expenditure category:		
Construction		53,051
Expenditures before resales	807	
Expenditures at time of sale	7,663	4,705
Expenditures after the sale	1,614	1,742
Lenders' investment of cost of funds	468	1,281
Mortgage insurers' income	11	39
Subtotal	10,563	60,818
Multiplier effects	5,282	30,409
Total	15,845	91,227

Source: National Association of Realtors.

Because of the uniquely beneficial economic and social role demanded of the real estate industry, Congress has, over the years, enacted tax provisions to encourage homeownership and real estate investment. Included are provisions to allow the tax deductibility of home mortgage interest and real property depreciation and, under certain circumstances, the deferral or exclusion of capital gains on home sales. Congress has also provided tax credits for amounts spent to rehabilitate income producing and historic buildings.

These tax provisions encouraging homeownership and real estate investment resulted from a variety of reasons, and Mr. Chairman, the National Association of Realtors believes that for equally compelling reasons these provisions should not now be altered.

For example, taxpayers traditionally have been allowed a cost recovery for investing in commercial and/or residential housing structures. This deduction (which is also available for investment in machinery and equipment) reflects a reasonable cost allowance for the wear and tear, gradual obsolescence and loss of value to property due to inflation.

The current real property depreciation rules (ACRS) and the other provisions of the Economic Recovery Tax Act of 1981 (ERTA) were adopted by Congress in order to stimulate much needed private sector investment.

The ACRS provisions have been in effect for only an extremely brief period of time (less than 24 months, only 8 months during economic recovery). There has been limited experience with which to measure the success or failure of these depreciation provisions, especially in the area of commercial development.

Our economic forecasts show that business investment in new structures will likely remain relatively weak due to vastly different performances for investment in commercial structures, which includes office buildings, and industrial structures. Construction of commercial space, which is closely linked to the residential market, increased at an annual rate of 17 percent in real terms during the first quarter of 1983. In contrast, construction of new industrial structures declined by 31 percent during the first quarter of this year and could continue to decline through mid-1984 unless real long term interest rates, which remain at more than double their level of the past 20 years, decline much further.

We have confidence that if real interest rates drop further the investment incentives provided by ACRS will be allowed to have the very positive economic impact which Congress intended and will spur investment, increase capital formation and help to provide a sustainable economic recovery with lasting jobs creation. We understand from our contracts with members throughout the country that there are many projects waiting to begin as soon and if real rates of interest drop further. We are equally certain that any adjustment now in the existing depreciation calculations would create great investment uncertainty and would significantly discourage the desperately needed investment in industrial, commercial and residential building.

We would also note, Mr. Chairman, that investment in commercial and residential structures is not an unreasonably favored instrument under current law. Consider the following table showing effective tax rates for various major components of corporate capital over selected years beginning in 1953. As demonstrated, the effective tax rate in 1983 for both commercial structures (39 percent) and apartment buildings (33 percent) substantially exceeds that of industrial equipment (15 percent) and public utility structures (29 percent).

Note the historical trend showing that tax rates on investment declined during the early 1960's and then rose steadily as inflation increased. it is only with the enactment of ACRS that tax rates on these assets now approach the rates of 1965 when commercial and residential investment and the economy were booming. Also, while the effective tax rates on commercial structures and apartment buildings have remained relatively high over the 1953-1980 period, the rates on other assets have declined substantially over the same period (primarily because the investment tax credit is available for equipment and not for structures (see Table 1).

TABLE 1.—ESTIMATED EFFECTIVE TAX RATES, CORPORATE SECTOR

	Industrial equipment	Public utility structures	Commercial structures	Apartment buildings
1953	.58	.53	.50	.43
1954	.50	.46	.44	.38
1961	.50	.46	.44	.38
1962	.29	.39	.44	.38
1965	.09	.33	.40	.33
1968	.30	.42	.46	.39
1970	.49	.45	.50	.39
1971	.21	.36	.50	.39
1974	.25	.38	.50	.39
1975	.09	.29	.50	.39
1980	.16	.31	.50	.39
1981	.04	.27	.39	.33
1982	.17	.27	.39	.33
1983	.15	.29	.39	.33

A further depreciation adjustment now; expanding the disincentive to real estate investment demonstrated by Table 1, can be expected to create great investment uncertainty and delay, weaken, or possibly about the economic recovery which is now being threatened by increasing interest rates.

For example, Table 2 shows the dramatic affect of applying full recapture of depreciation to rental residential buildings. Such a change would clearly disrupt investment decisions in this important sector of the economy—a dramatic and unjustified reversal in tax policy in less than two years.

TABLE 2.—IMPACT OF ALTERNATIVE RECAPTURE SCHEMES ON INTERNAL RATE OF RETURN ON INVESTMENT IN TYPICAL NEW RENTAL RESIDENTIAL BUILDING

Recapture scheme			Percentage change from current law in internal rate of return (percent per year)		
Depreciation rate	Life	Recapture	Holding period (years)		
			5	10	15
S.L. (current law)	15 yr	Sec. 1250			
S.L.	15 yr	Sec. 1245	−21	−10	−5
175 percent (current law)	15 yr	Sec. 1250			
175 percent	15 yr	Sec. 1245	−20	−9	−5

The tax provisions regarding taxable gain on home sales and rehabilitation tax credits provide equally compelling public policy justifications.

Current law provides that capital gains taxes on home sales may be deferred so long as the seller buys another home within 2 years costing at least as much as the home sold. Additionally, the first $125,000 of capital gains on a home sold by a taxpayer age 55 or older is excluded from taxation. The deferral or exclusion of capital gains taxation on home sales is clearly justified because the gains generally reflect simply a rise in housing prices due to inflation. An immediate tax on this gain would greatly reduce the ability of a seller to replace the home sold and would impose an undue hardship on those individuals selling their homes for personal, uncontrollable reasons; for instance, to relocate because of employment opportunties.

The age 55 exclusion is particularly wise public policy designed to ease the heavy tax burden which could result to older Americans when they decide to sell a lifelong residence to become renters or to move to a less costly residence. Without this provision, many older Americans would stay in housing which they no longer want or need—thus reducing the available housing stock for others.

The National Association of Realtors®, and presumbly the millions of homeowners who may someday be required to relocate, support continuation of the existing provisions relating to the capital gains taxation on home sales.

These provisions help to assure a strong housing market and, as a consequence, a healthy economy. Assuming continuation of current law, we expect about 2.7 million existing units to change hands in 1983—38 percent above the 1982 level. Resales should continue at a healthy pace during 1984 providing the foundation for lasting economic recovery.

Tax credits for the rehabilitation of older buildings and historic structures were enacted as part of Congress' strong desire to encourage renovation of existing premises rather than simply abandoning older buildings for new structures. These credits are an important part of renovating and preserving this nation's cities and historic structures. We know of many renovation projects, for instance in the cities of Nashville, Tennessee or Newport News, Virginia, which simply could not have been done without these tax credits. The National Association of Realtors ®would hope that these rehabilitation tax credits continue to be available; especially in light of the Administration's interest in revitalizing cities through the use of "enterprise zones."

CONCLUSION

We believe the housing and economic recovery is jeopardized by projections of enormous deficits into the foreseeable future and the effect such projections have on interest rates. We urge Congress to adopt a reasonable fiscal plan of across-theboard effect. Tax increases should focus on consumption and not saving and investment.

Housing investment and real estate development require long term certainly in investment strategy. Constant investment tax policy changes or adjustments create uncertainty which will stifle investment and very possibly upset the economic recovery now under way.

Mr. **Hance**. Thank you.

Mr. Schroyer.

STATEMENT OF THOMAS M. SCHROYER, VICE PRESIDENT OF FINANCE, TURCO DEVELOPMENT CO., ON BEHALF OF THE NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS

Mr. **Schroyer**. Thank you for the opportunity to testify.

In the interest of time, I will summarize my statement.

I am Thomas M. Schroyer, vice president of finance for Turco Development Co., headquartered in St. Louis, Mo. We are currently planning projects in excess of $100 million and we employ on an average annual basis approximately of 300 persons.

I testify before you on behalf of my company and the National Association of Industrial and Office Parks. One of the purposes of these 3 days of hearings is to explore ways of meeting the revenue raising requirements of the congressional budget resolution. I note that the congressional budget office has suggested that one possible source of additional revenue can be found by simply extending the recovery period for structures from 15 to 20 years. This recommendation may appear on first impression to be an insignificant change.

However, I would ask this committee to approach the subject of modifying the depreciation rules with the greatest caution. Any change at this point could seriously disrupt the recovery that is only barely under way in our industry and as a result reduce significantly the projected revenue that CBO says might be raised by a change in the ACRS.

Today I will examine the effect of ACRS on our industry, specifically on the ability of real estate developers to stimulate economic growth, increase employment and expand the tax base in communities throughout this Nation.

First, the real estate industry consists of a large number of very small businesses. The industry is highly sensitive to changes in the Internal Revenue Code because we are very capital intensive and returns on investment are subject to long-term risk. When you consider the interrelationship of real estate and other industries and the dependence of other sectors of the economy on the products and services of the real estate industry, any changes in the code can have a far-ranging effect on the entire economy.

These conclusions are not speculative—they are based on our experience and they are supported by a study conducted by the accounting firm of Coopers & Lybrand on behalf of the National Realty Committee. The study employed an economic model which has been given the acronym CLEFS (Coopers & Lybrand economic forecast simulator) and is capable of analyzing the effects of various proposed changes in the tax laws on the economy and upon investment in real estate.

The model also is used by the Treasury Department under the acronym MAGPIE [model for analysis of Government policy impact on efficiency].

One of the benefits derived from the NRC CLEFS model is the profile which it has provided of the real estate industry and its importance to the national economy. The model uses a definition of the real estate industry which includes private contract construction, real estate services, and financial services serving real estate investments.

Among the specific characteristics of the industry which the model identifies are the following: The real estate industry is the fourth largest U.S. industry—in 1981 the industry produced $275.5 billion, or 12.2 percent of the private business sector's gross national product.

While real estate GNP has grown at an average annual rate of 3.3 percent since 1947 (which is about the same as the rest of the business sector), it is significant to note that growth slowed considerably after 1970—the constant dollar GNP growth rate fell to 2.4 percent between 1971 and 1981, compared with a rate of 3.0 percent for the private sector.

The real estate industry provided nearly 6 million jobs in 1981, or about 1 out of every 12 in the private sector; and to illustrate the small business characteristics of the industry, over 90 percent of the contract construction establishments employ 20 or fewer persons, and 95 percent of the real estate service establishments employ 20 or fewer persons.

In addition, the CLEFS study illustrates the contribution the real estate industry has made to financing the public sector. In 1979, the industry generated more than $41 billion in Federal tax receipts—that amounted to 8.4 percent of all Federal tax revenues.

In the same year, real estate accounted for nearly $70 billion in taxes paid to State and local governments representing nearly 29 percent of the total receipts at those levels.

From our own perspective, we have witnessed first hand a number of dramatic changes in the way our industry functions and the way once traditional practices have had to change to secure sources of equity and debt financing over the years.

During the 1970's, a developer generally was able to finance the land acquisition, design, and construction of a building by borrowing the majority of the capital at long-term fixed rates which allowed the developer to better predict his future expenses and to assess his long-term risks. In turn the long-term, fixed-rate capital was more often available because the lender capitalization requirements and the relatively predictable interest rates on which they were based permitted the lender to more accurately project his rate of return over the life of the loan.

The economic dislocation which our industry and many others have undergone since the late 1970's has completely reshaped the relationship between developers, investors, and lenders. More significantly, the higher capitalization rates and the reluctance of lenders to provide long-term, fixed-rate loans have sharply reduced the availability of borrowed capital for construction projects that can produce economic growth, new jobs, and generate more tax revenues.

Today, in order to obtain sufficient amounts of capital to engage in the same business and to build the same type of structure, the developer must pursue a variety of different sources of equity. This places him in competition for investment dollars with equity stocks, bond markets, and tax shelters such as those designed to attract investors to oil and gas development.

Third, I am concerned that there is a growing perception in Washington that the real estate industry has benefited handsomely from the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982. Some already have argued that it would not be inequitable to take some of those benefits back by extending the ACRS recovery periods for structures from 15 to 20 years with the goal of raising the CBO estimate of $19.4 billion over the next 5 years.

I don't believe that conclusion or the assumption on which it is based will stand up to your careful scrutiny.

ACRS represents only a limited reduction in actual depreciation periods for buildings. ERTA replaced the old depreciation rules for structures with a single 15-year cost recovery period. Previous depreciation periods for buildings have been calculated by using the facts and circumstances test. The change did not, as many would have you believe, reduce the recovery period for structures to 15 years from 40 or 50 years.

Before ERTA, the code permitted a developer to depreciate separately the component parts of a building—items such as heating and air-conditioning units, electrical and plumbing systems, and the carpeting and light fixtures, could be depreciated at different rates depending upon the asset depreciation range class to which it was assigned. In practice, under these rules depreciation taken during the first 10-year period of a project's life could be equivalent to a straight-line rate of 16 to 20 years (depending upon the component lives and the depreciation method used).

Apart from the lack of understanding between what was believed to have been the depreciation period for buildings and the actual periods that were being upheld using component depreciation, the assumption that real estate enjoyed significant benefits from ERTA fails to assess the net effect of the other restrictions which were imposed on investment activities involving buildings in either ERTA or TEFRA.

Not only did ERTA eliminate the use of component depreciation in exchange for shorter recovery periods, in the last 2 years Congress has imposed far more restrictive rules on the deduction of construction period interest and taxes, adopted more severe rules governing the recapture of depreciation, further limited the amount of interest investors can deduct, and expanded significantly the alternative minimum tax to include real estate activities.

Economic studies confirm that ERTA compounds restrictions on structures. The CRS published a study in August 1981 which confirms the tax law before ERTA favored investment in equipment assets instead of structures and that in quote, "Under ACRS this trend is continued and strengthened."

A study published last year by the Citizens for Tax Justice determined that under ERTA assets other than structures enjoyed a negative tax rate since the adoption of ACRS while commercial and industrial buildings have enjoyed a positive tax rate. I invite you to look at exhibit B which is included in my written statement.

Finally, the National Realty Committee study by Coopers and Lybrand provides an economic model which has been given the acronym CLEFS, standing for Coopers & Lybrand economic forecast simulator. This model is capable of analyzing the effects of various proposed changes in the tax laws on the economy and on investment in real estate. The model also is used by the Treasury Department under the acronym MAGPIE, which stands for model for analysis of Government policy impact on efficiencies.

This CLEFS model depicts a scenario where investments and equipment assets will continue for 1 year to the next but investment in structures will fall off by $67.3 billion by 1986 if the recovery period is stretched to 20 years. In addition, exhibit A, page 3 of my analysis of a national Turco project shows that the proposed extension will decrease overall average annual holding period investor returns by 6 percent per year but more importantly will decrease the average annual investor return by 9 percent per year in the most critical period of project which is the first 3.5 years or so.

Thus, extending the recovery period from 15 to 20 years will not create governmental true savings but merely defer the burden to future administrations and make it more difficult for developers to create their product in the first place.

In conclusion, the ACRS recovery periods were enacted to spur investment. By changing the rules Congress is running the risk of jeopardizing future development, jobs, and tax revenues. In fact, the project described in my exhibit could not have been consummated had a 20-year recovery period been in effect.

Our members are ready to meet the challenge of building workplaces of the future but it becomes difficult when we must deal with continual changes in the Tax Code. We urge you to refrain from changing again the ground rules under which our industry must operate.

ACRS is working. A change at this point could cause a setback in the recovery that is only barely underway.

Thank you.

[The statement of Mr. Schroyer follows:]

STATEMENT OF THOMAS M. SCHROYER ON BEHALF OF THE NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS

SUMMARY

I. Introduction

Thomas M. Schroyer, Vice President of Finance for Turco Development Company, St. Louis, Missouri, in testimony on behalf of the National Association of Industrial and Office Parks will address the Congressional Budget Office (CBO) estimate of raising $19.4 billion over the next five years by stretching the recovery period for structures from 15 to 20 years.

II. Evolution of the commercial real estate industry

(A) Profile of real estate industry.

(B) Current economic dislocation.

III. ACRS and proposals to extend the recovery period for structures

(A) ACRS represents only a limited reduction in actual depreciation periods for buildings.

(B) Economic studies confirm that ERTA compounds discrimination against structures.

(C) Economic model shows that longer recovery periods would slow real estate investment.

IV. Conclusion

NAIOP urges Members of the Committee on Ways and Means to refrain from changing the depreciation rules under which this industry is currently operating.

STATEMENT

I. Introduction

Mr. Chairman, I appreciate the opportunity to testify before this committee on the impact which the new Accelerated Cost Recovery System (ACRS) has had on the real estate industry and on proposals for broadening the federal tax base as required in the recently adopted congressional budget resolution.

I am Thomas M. Schroyer, and I am Vice President of Finance for Turco Development Company of St. Louis, Missouri. Turco is involved in the development of commercial real estate in the metropolitan St. Louis area.

During the past five years our company has developed more than one million square feet of industrial, office and commercial space in 35 buildings in St. Louis and St. Louis County. The company has a professional staff of 30 people, and utilizes the services of approximately 30 more people in outside marketing, technical and professional support. We also support approximately 250 additional people on each project who provide services in related construction labor and manufacturing, and architectural and engineering design.

I appear before you today on behalf of Turco Development Company and the National Association of Industrial and Office Parks (NAIOP). NAIOP is a membership organization of 2,500 professionals involved in master-planning, designing, financing, constructing, and managing industrial and office park properties worth more than $66 billion in the United States. Of our 2,500 members, nearly 1,500 are professional developers who have an ownership interest in an office park or building. The remaining NAIOP members are executives who support the development industry in areas such as banking, brokerage and construction services.

Today I will present an outline of our industry along with the revolutionary changes we have witnessed in the past few years and examine the effect that ACRS has had on our industry—specifically on the ability of real estate developers to stimulate economic growth, increase employment and expand the tax base in communities throughout this great nation of ours. I understand that one of the purposes of these three days of hearings is to explore ways of meeting the revenue raising requirements of the Congressional Budget Resolution. I note that the Congressional Budget Office has suggested that one possible source of additional revenue can be found by simply extending the recovery period for structures from 15 to 20 years.[1]

This recommendation may appear upon first impression to be an insignificant change. However, I would ask this committee to approach the subject of modifying the depreciation rules with the greatest caution because any change at this point could seriously disrupt the recovery that is only barely underway in our industry and as a result could reduce significantly the projected revenue that CBO says might be raised by a change in ACRS.

II. Evolution of the commercial real estate industry

Mr. Chairman, the real estate industry consists of a very large number of very small business organizations. In addition, the industry is highly sensitive to changes in the Internal Revenue Code because it is very capital intensive and returns on investment are subject to long-term risk. When you consider the interrelationship of real estate and other industries and the dependence of other sectors of the economy on the products and services of the real estate industry, any changes in the Code can have a far-ranging effect on the entire economy.

These conclusions are not speculative—they are based on our experience and they are supported by a study conducted by the accounting firm of Coopers & Lybrand on behalf of the National Realty Committee. The study employed an economic model which has been given the acronym CLEFS (Coopers & Lybrand Economic Forecast Simulator) and is capable of analyzing the effects of various proposed changes in the tax laws on the economy and upon investment in real estate. The model also is used by the Treasury Department under the acronym MAGPIE (Model for Analysis of Government Policy Impact on Efficiency).

One of the benefits derived from the NRC CLEFS model is the profile which it has provided of the real estate industry and its importance to the national economy. The model uses a definition of the real estate industry which includes private contract construction, real estate service, and financial services serving real estate investments. Among the specific characteristics of the industry which the model identifies are the following:

> The real estate industry is the fourth largest U.S. industry—in 1981 the industry produced $275.5 billion, or 12.2 percent of the private business sector's gross national product.
>
> While real estate GNP has grown at an average annual rate of 3.3 percent since 1947 (which is about the same as the rest of the business sector), it is significant to note that growth slowed considerably after 1970—the constant dollar GNP growth rate fell to 2.4 percent between 1971 and 1981, compared with a rate of 3.0 percent for the private sector.
>
> The real estate industry provided nearly six million jobs in 1981, or about one out of every 12 in the private sector.
>
> And to illustrate the small business characteristics of the industry, over 90 percent of the contract construction establishments employ 20 or fewer persons, and 95 percent of the real estate service establishments employ 20 or fewer persons.[2]

In addition, the CLEFS study illustrates the contribution the real estate industry has made to financing the public sector. In 1979, the industry generated more than $41 billion in federal tax receipts—that amounted to 8.4 percent of all federal tax revenues. In the same year, real estate accounted for nearly $70 billion in taxes paid to state and local governments representing nearly 29 percent of the total receipts at those levels.[3]

From our own perspective, we have witnessed first-hand a number of dramatic changes in the way our industry functions and the way once traditional practices have had to change to secure sources of equity and debt financing over the years.

During the 1970s, a developer generally was able to finance the land acquisition, design and construction of a building by borrowing the majority of the capital at long-term fixed rates which allowed the developer to better predict his future expenses and to assess his long-term risks. In turn the long-term fixed-rate capital was more often available because the lender capitalization requirements and the relatively predictable interest rates on which they were based permitted the lender to more accurately project his rate of return over the life of the loan.

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[1] "Reducing the Federal Deficit: Spending and Revenue Options," Congressional Budget Office, February 1983, part III, at 288–289.

[2] National Realty Committee, "Study of the Impact of ERTA and TEFRA on the Depreciation of Structures," June 1983 (Prepared for the NRC using the Coopers & Lybrand Economic Forecast Simulator).

[3] NRC CLEFS Study.

The economic dislocation which our industry and many others have undergone since the late 1970s has completely reshaped the relationships between developers, investors and lenders. More significantly, the higher capitalization rates and the reluctance of lenders to provide long-term fixed rate loans have sharply reduced the availability of borrowed capital for construction projects that can produce economic growth, new jobs and generate more tax revenues.

Today, in order to obtain sufficient amounts of capital to engage in the same business and to build the same type of structure, the developer must pursue a variety of different sources of equity. This places him in competition for investment dollars with equity stocks, bond markets and tax shelters such as those designed to attract investors to oil and gas development. If the developer is going to be successful, his investment must provide a return on his investors' equity which is competitive with alternatives available to them in the marketplace. That developer cannot offer a competitive rate of return if his ability to recover his cost basis is inferior to those offering other forms of investment.

Traditionally, it has been the small- and medium-sized developer that has been caught in this equity vise. The larger developer more often has had the leverage to negotiate more favorable lending terms with larger banks and institutional investors. The small developer, however, must accept the greater demands for equity participation by lenders, and in many cases, still seek equity capital from limited partner investors. This latter form of investment has provided a vital source of capital to the small- and medium-sized developer, and it has offered the small investor an opportunity to participate in the ownership of real property which under most other circumstances would be impossible.

Unfortunately, the recent upheavals in the real estate market have not been confined to the difficulties in raising capital. Unprecedented rates of inflation have had a direct impact on all aspects of our business from the labor and material costs of construction to reduced corporate expansion plans and higher building vacancy rates. The costs of acquiring land has escalated geometrically in several areas of the country. In many instances, the builder who was able to continue construction through this difficult period is now unable to pass on many of those inflated costs because the otherwise welcome decline in the rate of inflation has brought with it depressed lease values in terms of leases being put into effect today. In addition, increased competitiveness in the leasing market has given prospective tenants the leverage to withhold from signing leases until additional concessions are agreed to or until the developer grants them some form of ownership.

III. ACRS and proposals to extend the recovery period for structures

As I appear before you today, I am concerned that there is a growing perception in Washington that the real estate industry has benefited handsomely from the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982. Some already have argued that it would not be inequitable to take some of those benefits back be extending the ACRS recovery periods for structures from 15 to 20 years with the goal of raising the CBO estimate of $19.4 billion over the next five years. I don't believe that conclusion or the assumption on which it is based will stand up to your careful scrutiny.

A. ACRS represents only a limited reduction in actual depreciation periods for buildings.—ERTA replaced the old depreciation rules for structures with a single 15-year cost recovery period. Previous depreciation periods for buildings have been calculated by using the "facts and circumstances" test. The change did not, as many would have you believe, reduce the recovery period for structures to 15 years from 40 or 50 years.

Before ERTA, the Code permitted a developer to depreciate separately the "component" parts of a building—items such as heating and air conditioning units, electrical and plumbing systems, and the carpeting and light fixtures, could be depreciated at different rates depending upon the asset depreciation range class to which it was assigned. In practice, under these rules depreciation taken during the first ten-year period of a project's life could be equivalent to a straight-line rate of 16 to 20 years (depending upon the component lives and the depreciation method used). To illustrate this point, I submit for the record an analysis we have made using an actual property development in St. Louis (see Exhibit A, page 5).

Apart from the lack of understanding between what was believed to have been the depreciation period for buildings and the actual periods that were being upheld using component depreciation, the assumption that real estate enjoyed significant benefits from ERTA fails to assess to the net effect of the other restrictions which were imposed on investment activities involving buildings in either ERTA or TEFRA.

Not only did ERTA eliminate the use of component depreciation in exchange for shorter recovery periods, in the last two years Congress has imposed far more restrictive rules on the deduction of construction period interest and taxes, adopted more severe rules governing the recapture of depreciation, further limited the amount of interest investors can deduct, and expanded significantly the alternative minimum tax to include real estate activities. In addition, by adopting a uniform cost recovery period, Congress limited the right of some investors who buy and rehabilitate used structures to establish even shorter useful lives than 15 years through a facts and circumstances test.

B. Economic studies confirm that ERTA compounds discrimination against structures.—A Congressional Research Service study has confirmed that the tax law before ERTA favored investment in equipment assets instead of structures and that "under ACRS this trend is continued and strengthened."[4]

Another study published last year reached the same conclusion. "Citizens for Tax Justice" determined that under ERTA assets other than structures enjoyed a negative tax rate since the adoption of ACRS (see Exhibit B.)

Even the 1982 Economic Report of the President states that ACRS under ERTA favored investments in machinery, equipment and vehicles over those in the industrial and commercial buildings.[5] An updated CRS study of ACRS released in January of this year notes that even though TEFRA modified some of the benefits for equipment assets, the bias against structures still exists under present law. Jane Gravelle, who authored this update, pointed out that the effective tax rates on new investments were 15 percent for equipment and 48 percent for structures (assuming a six percent rate of inflation).[6]

C. Economic model shows that longer recovery periods would slow real estate investment.—When ACRS was adopted in 1981, the 15-year recovery period for structures represented a compromise to add five more years to the preferred 10–5–3 method of depreciation. If Congress, only two years later, extends the 15-year period to 20 years, it would distort the relationship between structures and equipment from a 3 to 1 to a 4 to 1 ratio.[7]

I do not want to suggest that the 15-year recovery period under ACRS has not been helpful—it has, and we are seeing the industry respond in the early stages of an economic renewal with new and rehabilitated projects that might not otherwise have gone forward. However, the incremental difference has been significantly less for structures than it has for equipment.

The CLEFS model indicates that while we can expect a 2.96 percent increase in 1983, investment in commercial and rental residential structures over the investment that would have occurred before ERTA (with the increased investment in equipment reflecting the different relative treatment under ACRS) is expected to be 3.46 percent greater than it would have been without ERTA.[8]

The most disturbing conclusion reached by CLEFS concerns the effect on investment in buildings if the present law is maintained for all other assets but the recovery period for structures is stretched out to 20 years. Under that scenario, it is estimated that investment in equipment would continue to increase from one year to the next, but investment in structures would fall off by 3.63 percent in 1984, 3.84 percent in 1985 and 4.01 percent in 1986. In dollars and cents, that means that investment could be expected to decline by $20.4 billion in 1984, $22.4 billion in 1985, and $24.5 billion in 1986.[9]

Finally, while CBO has projected that an extension of the recovery period could raise tax revenues in future years, the CLEFS model sharply refutes that assumption and estimates that federal tax revenues would in fact decline by $300 million in 1984, $500 million in 1985 and $1 billion in 1986 because of the falloff in projects that otherwise would have been developed.[10]

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[4] J. Gravelle, "Effects of the Accelerated Cost Recovery System by Asset Type," CRS, August 1981, at 6.

[5] Economic Report of the President, February 1982, at 124.

[6] J. Gravelle, "Effective Corporate Tax Rates and Tax Changes in the 97th Congress," CRS, January 1983, at 6.

[7] NRC CLEFS study.

[8] NRC CLEFS study.

[9] Ibid.

[10] Ibid.

Mr. Chairman, I would like to submit for the record projections we have made using an actual property development in St. Louis and which tends to confirm the conclusions reached by the CLEFS model as to the probable decline in investment in structures (see Exhibit A, page 3). This example shows that the proposed extension of the recovery period from 15 to 20 years will decrease overall average annual holding period investor returns by 6 percent per year, but more importantly will decrease the average annual investor return by approximately 9 percent per year in the most critical period of the project (i.e., the first 3.5 years) from a risk standpoint. These reductions, in light of my previous comments as to the nature of the indsutry today, make the project substantially less competitive and thus jeopardize its feasibility from the start. Thus, in my opinion, stretching the recovery period from 15 to 20 years will not create any governmental "true" savings but merely defer the burden to future administrations and make it more difficult for developers to create their product in the first place.

When Congress adopted the Accelerated Cost Recovery System in 1981, it was designed to provide a stimulus for investment in new and existing assets in order to help bring about a general economic recovery. There is every evidence that the system is just beginning to work as Congress had planned. Our company is just beginning to move ahead with projects that had been on the drawing board for some time until the economic climate improved to the point that we could obtain sufficient debt and equity capital to proceed.

Our company, like many others, has spent months since ACRS was adopted planning the construction of developments that have a very long lead time. Any change now in ACRS would force us to again evaluate those projects and to slow down plans for future developments. That could prove very harmful to the economic recovery because it would reduce the number of new jobs that might be created, it would cause a decline in the purchase of materials and equipment from companies that supply the building industry and it would produce, as the CLEFS model suggests, a significant drop in federal and state tax revenues.

IV. CONCLUSION

Mr. Chairman, our company and the members of NAIOP believe that we can help make a significant contribution to the future economic growth of our country. We are building the "workplaces of the future" because as our economy becomes more information and service oriented, the structures which house growth-oriented companies must be increasingly more efficient and make a recognizable contribution to job productivity.

Buildings today must incorporate the latest technological advancements in insulation, environmentsl control, lighting, communications and security. More and more, our buildings are becoming communications centers where employees readily can exchange information and data from office to office or from city to city by data processing networks which we incorporate in the design of the structures.

As companies expand and improve their information processing capabilities they will look more and more to the workplace to provide the environment and technology that will help make them more productive and more competitive.

We are ready to meet that challenge but it makes it increasingly difficult to put together the resources for the job when we must make continual readjustments for changes in the tax code that affect our ability to recover our costs and to obtain affordable capital.

We strongly urge you to refrain from changing again the ground rules under which our industry must operate. The record shows that ACRS is working and that a change at this point could cause a serious setback to the recovery that is only barely underway.

Thank you for this opportunity to comment.

EXAMPLE OFFICE BUILDING

NOTE.—The following information presents certain facts pertaining to an actual commercial multi-tenant office building project developed by Turco Development Company in St. Louis, Missouri. These facts are summarized based upon actual costs, financing, equity capital raised, and income and expense projections used in developing the project.

Office Building Project Summary

Costs:	
Land, syndication and other nondepreciable	**$440,000**
Depreciable/amortizable building costs	**2,087,000**
	2,527,000
Capital:	
Mortgage loan (nonparticipating, 13¼ percent)	**1,125,000**
Equity capital	**[1] 1,402,000**
Total	**2,527,000**

[1] 20 percent developer capital, 80 percent investor capital. During operating period, investor receives 11 percent preferential cash return on invested capital (to the extent that it is available) plus 80 percent of partnership taxable income/loss. Upon dissolution, investor receives 63.5 percent of net proceeds from dissolution.

OFFICE BUILDING BENEFIT SUMMARY

[In thousands of dollars]

	ERTA ACRS	
	15-yr	Proposed 20-yr
Capital investment	1,402	1,402
Benefits (expense) received during assumed holding period (10.5 yr):		
Cash:		
First 3.5 yr	231	231
Balance	1,298	1,298
Total	1,529	1,529
Tax:		
First 3.5 Yr: [1]	417	369
Balance	(276)	(311)
Total	141	58
Net holding period benefits	1,670	1,587
Summary—holding period benefits:		
First 3.5 yr	648	600
Balance	1,022	987
Total	1,670	1,587
Average annual percent returns: [2]		
First 3.5 yr	16.7	15.2
Balance	10.4	10.1
Average	12.5	11.8
Benefit upon sale: [3]		
Cash	2,536	2,536
Tax expense	1,118	1,035
Net	1,418	1,501
Summary of tax benefits (expenses):		
Holding period:		
First 3.5 yr	417	369
Balance	(276)	(311)
Sale	(1,118)	(1,035)
Net	(977)	(977)

OFFICE BUILDING BENEFIT SUMMARY—Continued

[In thousands of dollars]

	ERTA ACRS 15-yr	ERTA ACRS Proposed 20-yr
Tax benefit (expense) as a percent of original project cost:		
Holding period:		
First 3.5 yr	16.5	14.6
Balance	(10.9)	(12.3)
Sale	(44.3)	(41.0)
Net	(38.7)	(38.7)

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[1] Assumes 50 percent tax bracket investor.

[2] As measured against average outstanding capital investment. See exhibit A pp. 6 and 8 for details.

[3] Assumes gross sale price approximating 5 percent per year appreciation in project value (as measured against total original project cost). See exhibit A p. 4 for details.

OFFICE BUILDING SALE COMPUTATIONS

[In thousands of dollars]

	ERTA ACRS 15-yr.	ERTA ACRS Proposed 20-yr.
Gross sales price	3,800	3,800
Sales expenses	(210)	(210)
Net sales price	3,590	3,590
Mortgage balance	(1,063)	(1,063)
Sales proceeds	2,527	2,527
Working capital	9	9
Distributable cash	2,526	2,536
Basis	653	820
Gain:		
Ordinary income	1,768	1,602
LTCG	1,169	1,168
Total gain	2,937	2,770
Tax:		
Ordinary income	1,768	1,602
LTOG at 40 percent	468	467
Taxable income	2,236	2,069
Tax at 50 percent	1,118	1,035

OFFICE BUILDING PRE-ERTA COMPONENT DEPRECIATION SUMMARY

[In thousands of dollars]

Assumed holding period	Depreciation assuming method used was: Declining balance	Depreciation assuming method used was: Straight line
1982 (5 mo)	$67.4	$45.0
1983	149.9	107.9
1984	124.0	107.9
1985	112.5	107.9
1986	105.8	107.9
1987	87.2	89.7
1988	63.5	64.3

OFFICE BUILDING PRE-ERTA COMPONENT DEPRECIATION SUMMARY—Continued

[In thousands of dollars]

Assumed holding period	Depreciation assuming method used was	
	Declining balance	Straight line
1989	62.3	64.3
1990	61.4	64.3
1991	60.6	64.3
1992	52.9	56.4
Total	947.5	879.9
Average depreciation per year	$91.0	$84.5
Total original cost	$1,583.6	$1,583.6
Equivalent straight line rate (years)	17.4	18.7

Note: See detail computations per exhibit A. p. 10 and 11.

RETURN ANALYSIS—ERTA 15-YEAR ACRS

Year	Net cash flow	Reserve utilization	Add principal payments	Depreciation	Taxable income/ (loss)	Benefits			Average investment	After tax return
						Cash	Tax	Total		
1982 (5 mo)	49,000	65,600	500	140,986	−157,086	49,000	78,543	127,543	560,000	22.7
1983	53,700	39,900	3,200	296,919	−279,919	53,700	139,960	193,660	793,400	24.41
1984	50,700		3,600	281,083	−226,783	50,700	113,392	164,092	1,168,500	14.04
1985	77,800		4,100	253,328	−171,428	77,800	85,714	163,514	1,402,000	11.66
1986	117,400		4,700	203,351	−81,251	117,400	40,626	158,026	1,402,000	11.27
1987	129,400		5,300	121,965	12,735	129,400	−6,368	123,033	1,402,000	8.78
1988	155,800		6,100	104,156	57,744	155,800	−28,872	126,928	1,402,000	9.05
1989	179,400		7,000	104,156	82,244	179,400	−41,122	138,278	1,402,000	9.86
1990	200,800		8,000	90,290	118,510	200,800	−59,255	141,545	1,402,000	10.10
1991	242,500		9,100	90,290	161,310	242,500	−80,655	161,845	1,402,000	11.54
1992	272,700		10,400	81,557	201,543	272,700	−100,772	171,929	1,402,000	12.26
	1,529,200	105,500	62,000	1,768,081	−282,381	1,529,200	141,191	1,670,391	1,287,478	12.46

DEPRECIATION AND AMORTIZATION—ERTA 15-YEAR ACRS

Year	Building								Organizational costs	Other fees	Construction interest and loan costs	Lease costs	Non-depreciable costs	Total
	Shell cost	Plumbing and electric	Elev, roof, sheet metal, HVAC	Paving, hardware, land-scape	Paint and tenant finish	Sec. 38 property		Total building						
						Ems, lights, recept.	Carpet and other							
Useful life in years	15	15	15	15	15	5	5		5	3	10	4		
Cost	775,100	103,400	320,500	88,500	122,100	101,100	95,900	1,583,600	33,800	100,000	209,600	160,000	440,000	2,527,000
1982 (5 mos)	37,605	5,170	16,025	4,425	6,105	15,165	14,385	98,880	2,817	13,889	8,733	16,667		140,986
1983	82,731	11,374	35,255	9,735	13,431	22,242	21,098	195,866	6,760	33,333	20,960	40,000		296,919
1984	75,210	10,340	32,050	8,850	12,210	21,231	20,139	180,030	6,760	33,333	20,960	40,000		281,083
1985	67,689	9,306	28,845	7,965	10,989	21,231	20,139	166,164	6,760	19,444	20,960	40,000		253,328
1986	60,168	8,272	25,640	7,080	9,768	21,231	20,139	152,298	6,760		20,960	23,333		203,351
1987	52,647	7,238	22,435	6,195	8,547			97,062	3,943		20,960			121,965
1988	45,126	6,204	19,230	5,310	7,326			83,196			20,960			104,156

1989	45,126	6,204	19,230	5,310	7,326			83,196			20,960			104,156
1990	37,605	5,170	16,025	4,425	6,105			69,330			20,960			90,290
1991	37,605	5,170	16,025	4,425	6,105			69,330			20,960			90,290
1992	37,605	5,170	16,025	4,425	6,105			69,330			12,227			81,557
Accumulated depreciation	579,117	79,618	246,785	68,145	94,017	101,100	95,900	1,264,682	33,800	100,000	209,600	160,000	0	1,768,082
Net book value	172,983	23,782	73,715	20,355	28,083	0	0	318,918	0	0	0	0	334,500	653,418

RETURN ANALYSIS—PROPOSED 20-YEAR ACRS

Year	Net cash flow	Reserve utilization	Add principal payments	Depreciation	Taxable income/(loss)	Benefits			Average investment	After tax return
						Cash	Tax	Total		
1982 (5 mo.)	49,000	65,600	500	127,120	−143,220	49,000	71,610	120,610	560,000	21.5
1983	53,700	39,900	3,200	269,187	−252,187	53,700	126,094	179,794	793,400	22.66
1984	50,700		3,600	253,351	−199,051	50,700	99,526	150,226	1,168,500	12.86
1985	77,800		4,100	255,596	−143,696	77,800	71,848	149,648	1,402,000	10.67
1986	117,400		4,700	189,485	−67,385	117,400	33,693	151,093	1,402,000	10.78
1987	129,400		5,300	108,099	26,601	129,400	−13,301	116,100	1,402,000	8.28
1988	155,800		6,100	104,156	57,744	155,800	−28,872	126,928	1,402,000	9.05
1989	179,400		7,000	90,290	96,110	179,400	−48,055	131,345	1,402,000	9.37
1990	200,800		8,000	90,290	118,510	200,800	−59,255	141,545	1,402,000	10.10
1991	242,500		9,100	76,424	175,176	242,500	−87,588	154,912	1,402,000	11.05
1992	272,700		10,400	67,691	215,409	272,700	−107,705	164,996	1,402,000	11.77
	1,529,200	105,500	62,000	1,601,689	−115,989	1,529,200	56,995	1,587,195	1,287,478	11.83

DEPRECIATION AND AMORTIZATION—PROPOSED 20-YEAR ACRS

Year	Building								Organizational costs	Other fees	Construction interest and loan costs	Lease costs	Nondepreciable costs	Total
	Shell costs	Plumbing and electric	Elev, roof, sheet metal, HVAC	Paving, hardware, landscape	Paint and tenant finish	Sec. 39 Property		Total building						
						EMS, lights, recept.	Carpet and other							
Useful life in years	20	20	20	20	20	5	5		5	3	10	4		
Cost	752,100	103,400	320,500	88,500	122,100	101,000	95,900	1,583,600	33,800	100,000	209,600	160,000	440,000	2,527,000
1982 (5 mo)	30,084	4,136	12,820	3,540	4,884	15,165	14,385	85,014	2,817	13,889	8,733	16,667		127,120
1983	67,689	9,306	28,845	7,965	10,989	22,242	21,098	168,134	6,760	33,333	20,960	40,000		269,187
1984	60,168	8,272	25,640	7,080	9,768	21,231	20,139	152,298	6,760	33,333	20,960	40,000		253,351
1985	52,647	7,238	22,435	6,195	8,547	21,231	20,139	138,432	6,760	19,444	20,960	40,000		225,596
1986	52,647	7,238	22,435	6,195	8,547	21,231	20,139	138,432	6,760		20,960	23,333		189,485
1987	45,126	6,204	19,230	5,310	7,326			83,196	3,943		20,960			108,099
1988	45,126	6,204	19,230	5,310	7,326			83,196			20,960			104,156
1989	37,605	5,170	16,025	4,425	6,105			69,330			20,960			90,290
1990	37,605	5,170	16,025	4,425	6,105			69,330			20,960			90,290
1991	30,084	4,136	12,820	3,540	4,884			55,464			20,960			76,424
1992	30,084	4,136	12,820	3,540	4,884			55,464			12,227			67,691
Accumulated depreciation	488,865	67,210	208,325	57,525	79,365	101,100	95,900	1,098,290	33,800	100,000	209,600	160,000	0	1,601,690
Net book value	263,235	36,190	112,175	30,975	42,735	0	0	485,310	0	0	0	0	334,500	819,810

DEPRECIATION AND AMORTIZATION—PRE-ERTA COMPONENT METHOD (150 PERCENT DDB)

Year	Building								Organizational costs	Other fees	Construction interest and loan costs	Lease costs	Nondepreciable costs	Total
	Shell costs	Plumbing and electric	Elev, roof, sheet metal, HVAC	Paving, hardware, landscape	Paint and tenant finish	Sec. 38 Property		Total building						
						EMS, lights, recept.	Carpet and other							
Useful life in years	40	20	15	10	5	10	5		5	3	10	4		

Cost	752,100	103,400	320,500	88,500	122,100	101,100	95,900	1,583,600	33,800	100,000	209,600	160,000	440,000	2,527,000
1982 (5 mo)	11,752	3,231	13,354	5,531	15,263	6,319	11,988	67,437	2,817	13,889	8,733	16,667		109,543
1983	27,763	7,513	30,715	12,445	32,051	14,217	25,174	149,878	6,760	33,333	20,960	40,000		250,931
1984	26,722	6,949	27,643	10,579	22,436	12,085	17,622	124,035	6,760	33,333	20,960	40,000		225,088
1985	25,720	6,428	24,879	8,992	20,265	10,272	15,916	112,471	6,760	19,444	20,960	40,000		199,636
1986	24,755	5,946	22,391	7,740	20,265	8,842	15,916	105,855	6,760		20,960	23,333		156,908
1987	23,827	5,500	20,152	7,740	11,821	8,842	9,285	87,166	3,943		20,960			112,069
1988	22,934	5,087	18,925	7,740		8,842		63,528			20,960			84,488
1989	22,074	4,706	18,925	7,740		8,842		62,286			20,960			83,246
1990	21,246	4,612	18,925	7,740		8,842		61,365			20,960			82,325
1991	20,449	4,612	18,925	7,740		8,842		60,568			20,960			81,528
1992	19,682	4,612	18,925	4,515		5,158		52,892			12,227			65,119
Accumulated depreciation	246,923	59,198	233,759	88,500	122,100	101,100	95,900	947,480	33,800	100,000	209,600	160,000	0	1,450,880
Net book value	505,177	44,202	86,741	0	0	0	0	636,120	0	0	0	0	334,500	970,620

DEPRECIATION AND AMORTIZATION—PRE-ERTA COMPONENT METHOD (SL METHOD)

Year	Building								Organizational costs	Other fees	Construction interest and loan costs	Lease costs	Nondepreciable costs	Total
	Shell costs	Plumbing and electric	Elev, roof, sheet metal, HVAC	Paving, hardware, landscape	Paint and tenant finish	Sec. 38 property		Total building						
						Ems, lights, recept.	Carpet and other							
Useful life in years	40	20	15	10	5	10	5		5	3	10	4		
Cost	752,100	103,400	320,500	88,500	122,100	101,100	95,900	1,583,600	33,800	100,000	209,600	160,000	440,000	2,527,000
1982 (5 mo.)	7,834	2,154	8,903	3,688	10,175	4,213	7,992	44,958	2,817	13,889	8,733	16,667		87,064
1983	18,803	5,170	21,367	8,850	24,420	10,110	19,180	107,899	6,760	33,333	20,960	40,000		208,953
1984	18,803	5,170	21,367	8,850	24,420	10,110	19,180	107,899	6,760	33,333	20,960	40,000		208,953
1985	18,803	5,170	21,367	8,850	24,420	10,110	19,180	107,899	6,760	19,444	20,960	40,000		195,064
1986	18,803	5,170	21,367	8,850	24,420	10,110	19,180	107,899	6,760		20,960	23,333		158,953
1987	18,803	5,170	21,367	8,850	14,245	10,110	11,188	89,733	3,943		20,960			114,636
1988	18,803	5,170	21,367	8,850		10,110		64,299			20,960			85,259
1989	18,803	5,170	21,367	8,850		10,110		64,299			20,960			85,259
1990	18,803	5,170	21,367	8,850		10,110		64,299			20.960			85,259

DEPRECIATION AND AMORTIZATION—PRE-ERTA COMPONENT METHOD (SL METHOD)—Continued

Year	Building								Organizational costs	Other fees	Construction interest and loan costs	Lease costs	Nondepreciable costs	Total
	Shell costs	Plumbing and electric	Elev, roof, sheet metal, HVAC	Paving, hardware, landscape	Paint and tenant finish	Sec. 38 property		Total building						
						Ems, lights, recept.	Carpet and other							
1991	18,803	5,170	21,367	8,850		10,110		64,299			20,960			85,259
1992	18,803	5,170	21,367	5,163		5,898		56,399			12,227			68,626
Accumulated depreciation	195,859	53,854	222,569	88,500	122,100	101,100	95,900	879,883	33,800	100,000	209,600	160,000	0	1,383,283
Net book value	556,241	49,546	97,931	0	0	0	0	703,717	0	0	0	0	334,500	1,038,217

TABLE II-4.—EFFECTIVE CORPORATE TAX RATES ON THE INCOME FROM NEW INVESTMENTS UNDER THE REAGAN ACCELERATED COST RECOVERY SYSTEM

[In percent]

Type of asset	Effective corporate tax rate					
	1981	1982	1983	1984	1985	1986
Office, computing, and acct. machinery	−30	−53	−67	−70	−178	−194
Trucks, buses, and trailers	−28	−48	−60	−63	−150	−163
Autos	−20	−37	−48	−52	−83	−97
Aircraft	−20	−33	−40	−42	−84	−89
Construction machinery	−19	−31	−37	−39	−77	−81
Mining and oil field machinery	−18	−29	−35	−37	−72	−76
Service industry machinery	−18	−29	−35	−37	−72	−76
Tractors	−18	−29	−35	−37	−71	−75
Instruments	−17	−27	−32	−33	−64	−67
Other equipment	−17	−27	−32	−33	−64	−67
Metalworking machinery	−14	−22	−26	−27	−50	−52
General industrial equipment	−14	−22	−26	−27	−50	−52
Electrical machinery	−13	−21	−25	−26	−48	−50
Furniture and fixtures	−13	−20	−24	−25	−44	−46
Special industry machinery	−12	−19	−22	−23	−41	−43
Agricultural machinery	−11	−18	−21	−22	−39	−41
Fabricated metal products	−11	−17	−20	−21	−37	−38
Engines and turbines	−10	−15	−18	−19	−32	−33
Ships and boats	−9	−15	−17	−18	−31	−32
Railroad equipment	−9	−13	−16	−16	−28	−29
Mining exploration, shafts, and wells	−8	−12	−14	−15	−25	−25
Residential buildings	+31	+29	+29	+29	+29	+29
Commercial buildings	+36	+34	+34	+34	+33	+33
Industrial buildings	+39	+37	+37	+37	+37	+37
Weighted averages	−8	−18	−23	−25	−58	−63
Maximum gap between rates (maximum distortion effect)	69	90	104	107	215	231

Notes: Negative numbers mean government subsidies for the investments, in the form of reduced taxes on other income or through tax leasing. Weighted averages are based on each asset category's share of 1978 corporate investment. (Assets covered represent 87 percent of 1978 corporate investment.)

Source: Based on data, methodology, and sources from the "Economic Report of the President," February 1982, p. 123. (An apparent typographical error in the report, dealing with trucks, trailers, and buses, has been corrected.)

Mr. HANCE. Thank you very much, Mr. Schroyer. Let me ask you, you heard the prior testimony and you heard my questions about the 3-percent reduction in COLA's on entitlements and tax indexation. How would your members feel about that?

Mr. SCHROYER. The NAIOP has yet to develop a formal position on those matters but as such at this time I would say we basically have little to comment on in terms of the contingency tax. We are currently reviewing with interest the provisions of the chairman's tax freeze proposal and would like the opportunity to make further comments sometime in the near future on this and on the issue of indexing and contingency tax.

Mr. HANCE. Thank you very much.

I have a couple questions to both the realtors and the homebuilders, I think these are questions that several members had and several would like to have asked this, given your concern other deficits, would you be willing to let mortgage subsidies bonds expire?

Mr. PRYDE. Let them expire? The tax exempt mortgage revenue bonds?

Mr. HANCE. Yes.

Mr. PRYDE. No, we think that is a very important part of the housing program. It contributes some 70,000 units a year now. We have a very fragile recovery out there contrary to what some of the economists are saying.

With interest rates having turned up now, we see the dramatic turndown over the past 3 or 4 weeks across the country in terms of sales and traffic. So I think it would be a mistake to sunset the tax revenue bonds at the end of this year.

Mr. **Hance**. Dr. Carlson.

Mr. **Carlson**. If your point is, would we be willing to sacrifice along with the rest of the economy to try to get the deficit in line, the answer is yes. For example, we petitioned the President to veto the HUD appropriation bill which has an overrun over his spending of $6 billion, and many of those programs affect our constituency.

We are disappointed the President did not veto this budget-busting bill.

Mr. **Hance**. You would be willing to give it up but you want somebody else to share the burden with you. In other words you don't want to give that up——

Mr. **Carlson**. On the HUD appropriation bills program. On the tax exempt bonds you have to recognize that the 1981 law put homeownership at a disadvantage versus rental investment. Consequently, moving in the direction of discouraging homeownership further by removing the availability of tax exempt bonds is bad for many reasons, especially as interest rates show signs of again increasing to prohibitive levels.

So it is really how you have us take our pain along with everybody else's pain that is important. Clearly if you choose the wiser route for us to take pain we will join with the rest of the economy to get the deficit down.

Mr. **Hance**. Thank you.

Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman.

I want to thank the panel and may I say I am not as familiar with Mr. Schroyer's group as I am with the homebuilders and the realtors. But I do want to compliment you on the leadership that you have given your organizations because I don't know of any organizations that have given more, sacrificed more for this country than your groups have in the past 2 or 3 years, where you have asked your members to sacrifice and they have.

They have always come forth saying, we will and we will if everybody else will, and when everybody else didn't your group still did. So it is a tribute to the leadership you are giving your groups.

Would you care to comment more on the increasing interest rates that we have been reading about, the prime rate and also the FHA rate. What is it doing to the selling of homes or building of homes?

Mr. **Pryde**. Well, we see that as a bad omen. As I said in my testimony we have seen a dramatic turndown in sales in the past 4 to 6 weeks which ties into basically the half a percent increase in the HUD—FHA—rate which was in the first part of June. Consumers are very sensitive to the interest rate.

Perhaps not as much in terms of whether they can afford or qualify. Half a percent has a direct bearing on that.

But it is the psychological aspect that is perhaps the more important one than the actual increase, and that is a serious one out there because it is turned off a lot of sales. It hasn't come through statistically yet but in our meeting of the Executive Committee last week where we have representatives from all parts of the country on the Executive Committee coming in, that was the unanimous feeling—all around the country—that there has been a turndown in sales and traffic.

So the interest rate increase is a serious one.

Mr. DUNCAN. Did the half percent trigger also in the conventional mortgages?

Mr. CARLSON. Yes, sir. In fact you had back-to-back 1 month after the other a half percent and half percent, a total of 1 percent increase in the FHA rates. Given the sensitivity over history of interest rates, especially above the inflation rate, what we expect is probably 150,000 fewer homes being built and about 300,000 people exchanging homes to upgrade to a more adequate home. That will have a fundamental impact on slowing down this recovery.

Also, it is interesting to note that in our lifetime mortgage interest rates have been 2 to 3 percent above the underlying inflation rate. So if the underlying rate is 5 percent, 12.5 is 7.5 percent over the inflation rate and this is 3 times the normal rate difference we have had in history and consequently we are anti-investment posturing now with such rates and it is not only housing, though that is the longest life asset, but it involves any long-lived asset we have in our economy and will reduce the ability for us to grow before we run into limitations on investments.

Mr. DUNCAN. What would you recommend we could do as members of the Congress for an immediate effect?

Mr. CARLSON. I think the practical political realities from our perspective is you have to reduce consumption stimulating tax incentives, the tax cuts you would otherwise have take place, not have them take place to the full extent; and you ought to limit the stimulation for consumption on the spending side and not hurt the investment side and the human capital investment side of the economy.

The three for all program we are advancing will do it. Three percent less on the entitlement side and 3 percent off the indexing of the personal income tax brackets. That will give you a balanced budget in 5 years. It will help overcome your structural deficit.

Mr. DUNCAN. If we didn't put the tax into effect, or as you say take it off, I don't think we can do that any time immediately. But if we did take it off and left it where it is and didn't reduce spending it would not have any effect, would it?

Mr. CARLSON. Frankly speaking I don't think politically you can get together on that. Some parties contend you slow the growth of entitlements, others contend you dampen indexing. This is a happy marriage. No, you cannot get the structural deficit removed by any tax increase that I can see, including the 1 percent surcharge talked about. You cannot close the gap.

Mr. DUNCAN. Would you care to comment on that, Mr. Schroyer?

Mr. SCHROYER. I have to agree. I personally feel that Senator Danforth's bill which suggests that escalations in certain Government programs be reduced by CPI minus 3, personally that seems to follow the same lines. I think that I look at this question similarly to the way I look at my own business and that is when I am faced with a situation of looking down the road and looking at a loss situation, where do I look first? I certainly don't go to my employees and say, return some of your salaries. My first step is to first look at my own balance sheet and look where I can save and look where I can increase productivity of my own assets and search out my nonproductive assets.

I also can look to try to cut expenditures. If I cannot do that and it is—you know the Government is no different than my business in that respect—I try to do it to the best that I can but I certainly don't go off in different directions and try to affect other people's pocketbooks without first looking at my own.

Mr. DUNCAN. Thank you very much.

Mr. PRYDE. Could I add, Mr. Chairman, the point that there has been a growing discrepancy between starts and sales. Sales are lagging behind starts now at almost a 20-year high. So we do have that big discrepancy out there that concerns us. Inventories are building up.

On the tax question, we really feel it is a combination of approaches rather than either/or, and what is more important than anything else is that you have the immediate action take place this year—not after the election year. That is where we are really coming from.

I feel that is extremely important.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. HANCE. Thank you.

Gentlemen, we appreciate your being here.

The meeting will stand adjourned until 10 a.m. in the morning when we will resume hearings on this matter.

[Whereupon, at 1 p.m., the hearing was adjourned, to reconvene at 10 a.m., Thursday, July 21, 1983.]

REVENUE INCREASE PROPOSALS

THURSDAY, JULY 21, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10:24 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will please come to order.

Good morning, ladies and gentlemen. We are pleased this morning to have a very distinguished panel join us in our discussions on the economy and some of the remedies that might be endorsed or enacted to help the economy through this period.

Our panel this morning is comprised of Mr. Rohatyn and Mr. Robert Reischauer who I ask to join us at the witness table. Welcome to the Committee on Ways and Means, gentlemen. It is a pleasure to have you with us today.

As you know, the Congress has passed a budget resolution which some people feel is unrealistic. However, I think that there is a thread running through all Members' thoughts that interest rates will ultimately be the problem that will drive us into a more serious discussion of what must be done with revenues.

Having said that, Mr. Rohatyn, please begin your testimony. The committee is ready to receive it.

STATEMENT OF FELIX G. ROHATYN, CHAIRMAN, MUNICIPAL ASSISTANCE CORP., AND SENIOR PARTNER, LAZARD-FRERES, NEW YORK, N.Y.

Mr. Rohatyn. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, it is always a pleasure for me to testify in front of the House Ways and Means Committee. You have asked me to address myself to the general outlook for the economy and to the specific possibility of revenue-raising measures. I will attempt to do so.

The economic recovery presently under way appears to have increasing strength and momentum. The stock market is booming, interest rates have come down significantly, despite some current nervousness, consumer spending is up, inflation is down, production is growing. That is welcome news to everyone.

There are two possible explanations for this recovery: (a) that supply-side economics works and that the tax and budget programs enacted in 1981, together with monetarism, are producing long-term, low-inflation, high-investment economic growth; or (b) that we are experiencing a normal cyclical rebound to a steep recession, stimulated by consumer spending, high deficits and easier money. In short, classical Keynesian recovery.

Of the two scenarios, the second one appears to be more close to the mark. Last summer, monetarism coupled with the deficits created by the 1981 budget program, created the steepest recession since World War II, the highest real interest and unemployment rates, and almost bankrupted the world. When some of our largest companies and credit institutions, followed by Mexico and Brazil, went to the edge of bankruptcy, the Fed reversed its tight money policy, lowered interest rates, increased the money supply helped by last summer's tax package, permitted the present recovery to take hold.

Inflation has been brought down dramatically by a worldwide contraction and 35 million unemployed in the industrial world, by the sharp reduction in oil prices as a result of reduced consumption, and by lower food prices as a result of good crops and good weather.

The boom in the stock market was triggered by lower interest rates driving funds from money market accounts into equities as well as by huge inflows of foreign capital looking to the dollar as political insurance and to our economy as the only safe haven. It was at least partly this inflow of foreign capital that permitted the financing of our deficit with a minimum of crowding out and a significant reduction in interest rates.

Given the depth of the recession and the stimulus provided by a $200 billion deficit and easier money, a recovery had to happen. It is consumer-led, deficit-financed and classically Keynesian in character. It is also pushed along by the stock market. The boom in the market has increased market values by over $600 billion since last summer.

Business Week cites a rule of thumb that 6 percent of increased market values is translated into consumer-spending. This alone amounts to almost $40 billion. The stock market boom has also brought with it massive speculative excesses which make the 1960's look tame, and which should be viewed with serious concern.'

This is not to deny real achievements by the Reagan administration. By the end of the last administration, we were headed for an inflationary disaster. Partly as a result of its own failures and partly as a result of forces beyond its control, the Carter administration left a legacy of double digit inflation, 20 percent interest rates and a runaway budget. The Reagan administration, with considerable help from the Federal Reserve and its chairman, Paul Volcker, was able to change the country's direction, and sharply reduce the rate of inflation.

President Reagan has managed to convince the majority of the American people that a price has to be paid for this change in direction and the people have responded generously and with greater patience than might have been expected. These are considerable achievements on the part of the President, although it is hard to deny that the price that was paid was borne by those least able to afford it.

Business, especially big business, will come out of the recession far stronger than before. Sharply reduced costs and breakeven points, higher liquidity as a result of lower interest rates and high stock prices, will result in significantly higher profits and competitive positions for most of our large companies. This is a considerable and valuable national asset.

However, despite a clear upturn in the economy, not many of our fundamental problems have been addressed, the future is heavily mortgaged and inflows of foreign capital have pushed the dollar to punitively high rates. We are still looking for the formula of stable growth, low unemployment, reasonably balanced budgets and a reasonably valued currency.

Achieving these goals will require the ability to affect long-term trends such as regional shifts, industrial capacity, educational capabilities, strategic objectives. It will require institutions that can take the long view and act accordingly.

To do so an active government, a business leadership committed to the future, and a realistic labor leadership will have to join forces to create the political climate to provide the adjustments.

To be specific, we must deal with our budget on a long-term basis. We must deal with our industrial and our regional weaknesses, we must coordinate stronger economic growth policies with our allies, and we must deal with the Third World debt.

First, the budget. New York City did not face up to its runaway budget problems until the market shut down on its notes in 1975. Sooner or later, the United States will have a market problem financing deficits of $200 billion and up. An occasional deficit, even one as large as the present one, can be financed and even be beneficial to recovery as we are seeing at present.

This, I am sure, is a somewhat recent discovery to many of my conservative friends. However, another 5 years of such deficits, or anything close to it, will push the national debt up from its present $1.2 trillion to almost double that amount. Interest costs, alone, would be over $200 billion annually. No conceivable growth in GNP can make this affordable. Sooner or later, sharp cutbacks in the growth of social costs and military spending, together with significant new revenues will have to be enacted. If Congress is unwilling or unable to face the spending cuts now, then it should adopt a spending freeze as an interim measure.

On the revenue side, I have consistently favored a 50-cent gas tax—which could produce up to $50 billion a year in revenues, or a combination gas tax and oil import fee. I would add to it a minimum corporate income tax of 25 percent to 30 percent and some version of the Bradley-Gephardt simplified personal income tax which carries a maximum rate of 28 percent.

Any tax package should be phased in as the economy recovers, and be geared to produce about $75 billion annually by the third year. Savings in entitlements and defense should be enacted so as to produce an equivalent amount.

The tax increases and spending cuts should be tied together and the deficit should be brought to below $50 billion by the fourth year. As part of such a package, the Fed could most probably ease interest rates down by at least another 2–3 percentage points; a 6 percent prime rate and single digit long-term rates could be the result. Lower interest costs and growth would close the remaining gap.

I approach the subject of taxes with skepticism and uncertainty. I believe that taxing all consumption is regressive and counterproductive; in the case of a VAT it only duplicates many State and local tax schemes that largely depend on sales taxes. Furthermore, the economic health of the United States is too heavily tied to strong consumer spending to risk imposing much heavier taxes on consumption. We can now see, for example, that the failure to stimulate investment after the 1981 tax cuts can only be reversed if very strong levels of consumer spending pull the economy out of the recession.

I believe, however, that higher taxes on energy can be absorbed by the economy. The effects of a significant gas tax can be mitigated by rebates to lower-income groups and by shifting to smaller cars that use gas more efficiently. Sales of big cars are booming again and companies such as GM and Ford are unable to meet the current standard for mileage per gallon of gas.

Our automobile industry has invested close to $100 billion to build efficient cars over the last decade, yet we are now acting as if the 1973 and 1979 oil shocks never existed. A stiff gas tax will raise revenues and drive us back to less consumption of gas. Both are desirable.

So, in my view, is a minimum corporate income tax. The corporate income tax is clearly justified on grounds of equity. We hear that such a tax inhibits investment and growth, but adequate capital formation can be encouraged by lower capital-gain taxes, reasonable maximum tax rates for earned and unearned income, and possibly, shorter holding periods on securities transactions. According to estimates by Data Resources, Inc., corporate earnings for fiscal 1985 will be about $282 billion. The Congressional Budget Office estimates that corporate tax payments in that year will be some $65 billion or about 23 percent.

Detailed analysis would be necessary for a precise estimate; but it seems plausible that a minimum rate in the 25–30 percent range could provide $20 billion in additional revenue, although one would obviously have to take such items as foreign taxes into account.

At the same time, the entire tax system would benefit from the proposal of Senator Bradley and Congressman Gephardt for simplifying both personal and corporate income taxes by reducing the number and amounts of income tax deductions. Their plan for three steps of tax levels, with a maximum personal income tax of 28 percent, would be fairer and simpler than our present tax structure, with its innumerable loopholes.

One strong advantage of the Bradley-Gephardt plan is that the indexing provision, passed in 1981, could also be repealed. The argument that inflation pushes taxpayers into higher and higher brackets loses much of its force if the maximum tax rate is 28 percent. Eliminating indexing would return $6 billion to the Treasury in fiscal year 1985, and perhaps $15 billion to $20 billion in 1986 when its effects are fully felt.

Resolution of the budget problem cannot be left until after the 1984 election. Senator Dole has called for a budget summit; such a summit is imperative. It should include the President, the Congressional leadership and the Chairman of the Federal Reserve.

If deficits are cut by this type of program, resulting lower interest rates and a cheaper dollar would permit us to conduct a more coordinated, aggressively growth-oriented program with our OECD partners. This would help our exports and would also facilitate dealing with the $600 billion of Third World debt which is both an economic drag on the West and a continuing danger to our banking system. Stretching out part of this debt at lower interest rates would provide additional stimulus to long-term recovery as well as protecting the banking system.

I have been in favor for some time of a major restructuring of Third World debt, involving some government guarantees to the banks in exchange for longer maturities and lower interest rates, together with coordination among central banks to limit fluctuations of the major trading currencies. Insofar as Third World debt is concerned, our present policy is to maintain the current practice of limited rollovers, at extremely high interest rates, in the hope that Western recovery will sufficiently stimulate Third World exports to permit debt service.

There is at least a possiblity that we may not attain a strong Western recovery unless the Third World can import large amounts of Western goods. This is a chicken and egg problems. The presently proposed increase in the IMF will be far short of what is needed and significantly greater credits for the Third World will be required from the Western banking system than the system can and will provide. The present exposure is simply too great.

There are two ways of coping with this: (a) to limit the exposure on some of the existing credits by the type of restructuring I have proposed; or (b) to limit the banks' exposure on new credits by some form of multinational guarantees.

Internationally, a carefully prepared international monetary conference should recommend a coordinated system to limit the fluctuations of the main Western trading currencies to manageable levels.

This is a highly technical subject, involving both central bank management of foreign exchange as well as central bank cooperation on monetary policies.

We are presently providing political insurance for all the flight capital in the world at no cost to the insured and at enormous cost to us as a result of an overvalued dollar. It is by no means certain that the lowering of interest rates alone, especially if it is not dramatic, will bring the dollar into more rational alignment with the deutsche mark and the yen. Absent such a realignment, we will sooner or later resort to protectionism. The only alternative to protectionism is an orderly international monetary system. It will not occur on its own.

A possible temporary measure, pending realignment of our currency, would be the imposition of a variable tariff, or tax, which would be keyed to a normalized exchange rate. For instance, if we take 200 yen to the dollar as a normal rate, the tariff or tax would be zero if the rate is 200 and would move up to 20 percent if the rate is 240. This would obviously not be limited to the yen, but would apply to all major currencies which are significantly out of line with the dollar.

Such an arrangement is clearly not perfect; it would be far better to have international agreements with respect to currency values. It is better than local content legislation or other permanent trade barriers. It would also eliminate the need for the kind of arrangements presently in place, such as so-called voluntary restraint agreements on automobiles.

In the 1960's, we enacted an interest-equalization tax to improve our balance of payments; what I am suggesting is an exchange equalization tax.

On the domestic front, inflation and employment must still be dealt with, to make sure the former is kept down and the latter is pushed up in a higher growth environment. I have always been tempted by some kind of legislated, tax-based incomes policy to control inflation; I am inclined to think, however, that it would not be practical. An equivalent, rough form of incomes policy would be to abandon multiyear labor contracts, with built-in COLA's, in favor of single-year labor contracts with retrospective profit-sharing or performance-based bonuses. This would come closer to the Japanese or German annual spring offensive to set wage increases. It would also become part of a business/labor/government cooperative approach that would be the basis for an explicit industrial policy.

Industrial policy does not mean "picking winners" or "bailing out losers." It does not mean favoring "high tech" or "low tech." It means restructuring our automotive industry to make it cost-and-quality competitive with its foreign competition and not allowing unrealistic foreign exchange rates to destroy our domestic manufacturers. It means restructuring our steel industry to make it into a world-class metallurgical industry. It means maintaining a viable machine tool industry. It means a long-range policy of energy independence—regardless of short-term reductions in oil prices—and additional government support to long-range research and development efforts that individual corporations cannot undertake.

It means major investment in transportation systems and harbors to help our exports and in urban infrastructures as well as the environment to maintain regional balance and quality of life. Investment in infrastructure has to rank equally with investment in defense.

Irving Shapiro, Lane Kirkland, and I chair a group of business and labor leaders presently studying various aspects of industrial policy. One of the options, which I would personally support, would consist of a tripartite Economic Development Board, along the lines proposed by President Carter in 1980, which was to be chaired by Lane Kirkland and Irving Shapiro. Made up of representatives of business, labor, and government, its policy tools could include trade, tax and credit assistance to specific industries or specific regions.

The Board could have, as one of its tools, a credit agency modeled after the Reconstruction Finance Corporation of the 1930's. The principles of assistance, whether for industrial investment or infrastructure investment, would be the same: shared sacrifice.

Trade, tax and credit assistance would always be conditioned on restructuring contributions by all parties, would be temporary and would be based on expert findings of a resulting viable, competitive industry.

I am opposed to a planned economy, and to government-owned industries. I believe that the free market is usually the best market. However, the free market is not always adequate and not always right. The free market would have condemned New York City, Lockheed, and Chrysler to bankruptcies that would have been both needless and expensive.

Limited use of government credit assistance, extensive restructuring and cooperation by business and labor turned them into viable enterprises, the former, the largest urban center with a balanced budget and adequate services; the latter profitable and competitive companies. That is what I am talking about.

Industrial and regional policy can only be part of a sound fiscal and monetary national policy. But it reflects a Government's commitment to help absorb the shocks of rapid adjustment, and to maintain social balance. Too many countries competing with us have such a policy in one form or another.

At this time, I doubt that any individual, any single party, any simple ideology can govern this country. We need a long-range national effort that is bipartisan in nature, not just in appearance, and cooperative in approach; that faces up to the reality of a multiracial society of widely differing skills and educational levels, and of a Nation that is more a continent than a country.

The recovery may well be lasting in which case the present philosophy of Government is likely to prevail for some time. Indeed, if I am wrong and if we have long-term steady growth, it should prevail for a very long time, and I would not be sorry. I would then be wrong, but rich, and there are worse things in life than that.

But if I am right, we will face, sooner rather than later, a national debt of $2 trillion, a Third World debt of $1 trillion, an out-of-control budget and most of our current social and economic difficulties, still prevailing, but on a larger scale.

If there is an alternative, it will be a policy committed to maintain our social gains by promoting economic growth and full employment while able to deliver balanced budgets; a free enterprise system working with an active Government to maintain its industrial and regional balance; and a Government ready to lead the West to an orderly international financial system and a tough-minded, realistic, unemotional foreign policy.

But none of this will be possible without the first step of fiscal responsibility. And that is why it is so important that this committee act wisely and act soon.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF FELIX G. ROHATYN, CHAIRMAN, MUNICIPAL ASSISTANCE CORPORATION

Mr. Chairman, members of the Committee, it is always a pleasure for me to testify in front of the House Ways and Means Committee. You have asked me to address myself to the general outlook for the economy and to the specific possibility of revenue-raising measures. I will attempt to do so.

The economic recovery presently under way appears to have increasing strength and momentum. The stock market is booming, interest rates come down significantly, despite some current nervousness, consumer-spending is up, inflation is down, production is growing. That is welcome news to everyone. There are two possible explanations for this recovery.

(a) That supply-side economics works and that the tax and budget programs enacted in 1981, together with monetarism, are producing long-term, low-inflation, high-investment economic growth; or

(b) That we are experiencing a normal cyclical rebound to a steep recession, stimulated by consumer spending, high deficits and easier money. In short, classical Keynesian recovery.

Of the two scenarios, the second one appears to me more close to the mark. Last summer, monetarism coupled with the deficits created by the 1981 budget program, created the steepest recession since World War II, the highest real interest and unemployment rates, and almost bankrupted the world. When some of our largest companies and credit institutions, followed by Mexico and Brazil, went to the edge of bankruptcy, the Fed reversed its tight money policy, lowered interest rates, increased the money supply helped by last summer's tax package, permitted the present recovery to take hold. Inflation has been brought down dramatically by a world-wide contraction and 35 million unemployed in the industrial world, by the sharp reduction in oil prices as a result of reduced consumption, and by lower food prices as a result of good crops and good weather.

The boom in the stock market was triggered by lower interest rates driving funds from money market accounts into equities as well as by huge inflows of foreign capital looking to the dollar as political insurance and to our economy as the only safe haven. It was at least partly this inflow of foreign capital that permitted the financing of our deficit with a minimum of crowding out and a significant reduction in interest rates.

Given the depth of the recession and the stimulus provided by a $200 billion deficit and easier money, a recovery had to happen. It is consumer-led, deficit-financed and classically Keynesian in character. It is also pushed along by the stock market. The boom in the market has increased market values by over $600 billion since last summer. Business Week cites a rule of thumb that 6 percent of increased market values is translated into consumer-spending. This alone amounts to almost $40 billion. The stock market boom has also brought with it massive speculative excesses which make the 1960s look tame, and which should be viewed with serious concern.

This is not to deny real achievements by the Reagan Administration. By the end of the last Administration, we were headed for an inflationary disaster. Partly as a result of its own failures and partly as a result of forces beyond its control, the Carter Administration left a legacy of double digit inflation, 20 percent interest rates and a runaway budget. The Reagan Administration, with considerable help from the Federal Reserve and its Chairman, Paul Volcker, was able to change the Country's direction, and sharply reduce the rate of inflation. President Reagan has managed to convince the majority of the American people that a price has to be paid for this change in direction and the people have responded generously and with greater patience than might have been expected. These are considerable achievements on the part of the President, although it is hard to deny that the price that was paid was borne by those least able to afford it.

Business, especially big business, will come out of the recession far stronger than before. Sharply reduced costs and breakeven points, higher liquidity as a result of lower interest rates and high stock prices, will result in significantly higher profits and competitive positions for most of our large companies. This is a considerable and valuable national asset.

However, despite a clear upturn in the economy, not many of our fundamental problems have been addressed, the future is heavily mortgaged and inflows of foreign capital have pushed the dollar to punitively high rates. We are still looking for the formula of stable growth, low unemployment, reasonably balanced budgets and a reasonably valued currency.

Achieving these goals will require the ability to affect long-term trends such as regional shifts, industrial capacity, educational capabilities, strategic objectives. It will require institutions that can take the long view and act accordingly.

To do so an active government, a business leadership committed to the future, and a realistic labor leadership will have to join forces to create the political climate to provide the adjustments.

To be specific, we must deal with our budget on a long-term basis. We must deal with our industrial and our regional weaknesses, we must coordinate stronger economic growth policies with our allies, and we must deal with the Third World debt.

First, the budget. New York City did not face up to its runaway budget problems until the market shut down on its notes in 1975. Sooner or later, the U.S. will have a market problem financing deficits of $200 billion and up. An occasional deficit, even one as large as the present one, can be financed and even be beneficial to recovery as we are seeing at present. This, I am sure, is a somewhat recent discovery to many of my conservative friends. However, another five years of such deficits, or anything close to it, will push the national debt up from its present $1.2 trillion to almost double that amount. Interest costs, alone, would be over $200 billion annually. No conceivable growth in GNP can make this affordable. Sooner or later, sharp cutbacks in the growth of social costs and military spending, together with significant new revenues will have to be enacted. If Congress is unwilling or unable to face the spending cuts now, then it should adopt a spending freeze as an interim measure.

I have consistently favored a 50 cent gas tax (which could produce up to $50 billion a year in revenues), or a combination gas tax and oil import fee. I would add to it a minimum corporate income tax of 25–30 percent and some version of the Bradley-Gephart simplified personal income tax which carries a maximum rate of 28 percent.

The tax package should be phased in as the economy recovers, and be geared to produce about $75 billion annually by the third year. Savings in entitlements and defense should be enacted so as to produce an equivalent amount.

Tax increases and spending cuts should be tied together and the deficit should be brought to below $50 billion by the fourth year. As part of such a package, the Fed could ease interest rates down by at least another 2–3 percent points; a 6 percent prime rate and single digit long-term rates could be the result. Lower interest costs and growth would close the remaining gap.

I approach the subject of taxes with skepticism and uncertainty. I believe that taxing all consumption is regressive and counterproductive; in the case of a VAT it only duplicates many state and local tax schemes that largely depend on sales taxes. Furthermore, the economic health of the US is too heavily tied to strong consumer spending to risk imposing much heavier taxes on consumption. We can now see, for example, that the failure to stimulate investment after the 1981 tax cuts can only be reversed if very strong levels of consumer spending pull the economy out of the recession.

I believe, however that higher taxes on energy can be absorbed by the economy. The effects of a significant gas tax can be mitigated by rebates to lower-income groups and by shifting to smaller cars that use gas more efficiently. Sales of big cars are booming again and companies such as GM and Ford are unable to meet the current standard for mileage per gallon of gas. Our automobile industry has invested close to $100 billion to build efficient cars over the last decade, yet we are now acting as if the 1973 and 1979 oil shocks never existed. A stiff gas tax will raise revenues and drive us back to less consumption of gas. Both are desirable.

So, in my view, is a minimum corporate income tax. The corporate income tax is clearly justified on grounds of equity. We hear that such a tax inhibits investment and growth, but adequate capital formation can be encouraged by lower capital-gain taxes, reasonable maximum tax rates for earned and unearned income, and possibly, shorter holding periods on securities transactions. According to estimates by Data Resources, Inc., corporate earnings for fiscal 1985 will be about $282 billion. The Congressional Budget Office estimates that corporate tax payments in that year will be some $65 billion or about 23 percent. Detailed analysis would be necessary for a precise estimate; but it seems plausible that a minimum rate in the 25–30 percent range could provide $20 billion in additional revenue, although one would obviously have to take such items as foreign taxes into account.

At the same time, the entire tax system would benefit from the proposal of Senator Bradley and Congressman Gephardt for simplifying both personal and corporate income taxes by reducing the number and amounts of income tax deductions. Their plan for three "steps" of tax levels, with a maximum personal income tax of 28 percent, would be fairer and simpler than our present tax structure, with its innumerable loopholes. One strong advantage of the Bradley-Gephardt plan is that the indexing provision, passed in 1981, could also be repealed. The argument that inflation pushes taxpayers into higher and higher brackets loses much of its force if the maximum tax rate is 28 percent. Eliminating indexing would return $6 billion to the Treasury in fiscal year 1985, and perhaps $15–$20 billion in 1986 when its affects are fully felt.

Resolution of the budget problem cannot be left until after the 1984 election. The President cannot remain aloof from the process. Senator Robert Dole has called for a budget "Summit"; such a "Summit" is imperative. It should include the President, the Congressional leadership and the Chairman of the Federal Reserve.

If deficits are cut by this type of program, resulting lower interest rates and a cheaper dollar would permit us to conduct a more coordinated, aggressively growth-oriented program without OECD partners. This would help our exports and would also facilitate dealing with the $600 billion of Third World debt which is both an economic drag on the West and a continuing danger to our banking system. Stretching out part of this debt at lower interest rates would provide additional stimulus to long-term recovery as well as protecting the banking system.

I have been in favor for some time of a major restructuring of Third World Debt (involving some government guarantees to the banks in exchange for longer maturities and lower interest rates) together with coordination among central banks to limit fluctuations of the major trading currencies. Insofar as Third World Debt is concerned, our present policy is to maintain the current practice of limited rollovers, at extremely high interest rates, in the hope that Western recovery will sufficiently stimulate Third World exports to permit debt service. There is at least a possibility that we may not attain a strong Western recovery unless the Third World can import large amounts of Western goods. This is a chicken and egg problem. Western economic growth in the 1970s was significantly fueled by Western exports to the Third World. This is necessary now, and it is in flat contradiction with IMF-imposed austerity and deflation. The presently proposed increase in the IMF will be far short of what is needed and significantly greater credits for the Third World will be required from the Western banking system than the system can and will provide. The present exposure is simply too great. There are two ways of coping with this: (a) To limit the exposure on some of the existing credits by the type of restructuring I have proposed; or, (b) to limit the banks' exposure on new credits by some form of multinational guarantees.

Internationally, a carefully prepared international monetary conference should recommend a coordinated system to limit the fluctuations of the main Western trading currencies to manageable levels.

This is a highly technical subject, involving both central bank management of foreign exchange as well as central bank cooperation on monetary policies.

We are presently providing political insurance for all the flight capital in the world at no cost to the insured and at enormous cost to us as a result of an overvalued dollar. It is by no means certain that the lowering of interest rates alone, especially if it is not dramatic, will bring the dollar into more rational alignment with the D-Mark and the yen. Absent such a realignment, we will sooner or later resort to protectionism. The only alternative to protectionism is an orderly international monetary system. It will not occur on its own.

The argument against such a proposal is that "convergent" economic policies will bring currencies into line and that absent such "convergent" policies, intervention is impractical. But we have "convergent" policies with Germany, U.K. and Japan and our currencies keep getting further and further out of line. We must try another approach.

A possible temporary measure, pending realignment of our currency, would be the imposition of a variable tariff, or tax, which would be keyed to a "normalized" exchange rate. For instance, if we take 200 yen/$ as a "normal" rate, the tariff or tax would be zero if the rate is 200 and would move up to 20% if the rate is 240. This would obviously not be limited to the yen, but would apply to all major currencies which are significantly out-of-line with the dollar.

Such an arrangement is clearly not perfect; it would be far better to have international agreements with respect to over main currency values. But it is better than "local content" legislation or other permanent trade barriers. It would also eliminate the need for the kind of arrangements presently in place, such as a so-called "voluntary" restraint agreements on automobiles.

In the 1960's we enacted an "interest-equalization tax" to improve our balance-of-payments; what I am suggesting is an "exchange equalization tax".

On the domestic front, inflation and employment must still be dealt with, to make sure the former is kept down and the latter is pushed up in a higher growth environment. I have always been tempted by some kind of legislated, tax-based incomes policy to control inflation; I am inclined to think, however, that it would not be practical. An equivalent, rough form of incomes policy would be to abandon multiyear labor contracts, with built-in COLA's, in favor of single-year labor contracts with retrospective profit-sharing or performance-based bonuses. This would come closer to the Japanese or German annual "Spring Offensive" to set wage increases. It would also become part of a business/labor/government cooperative approach that would be the basis for an explicit industrial policy.

Industrial policy does not mean "picking winners" or "bailing out losers". It does not mean favoring "high tech" or "low tech". It means restructuring our automotive industry to make it cost-and-quality competitive with its foreign competition and not allowing unrealistic foreign exchange rates to destroy our domestic manufacturers. It means restructuring our steel industry to make it into a world-class metallurgical industry. It means maintaining a viable machine tool industry. It means a long-range policy of energy independence (regardless of short-term reductions in oil prices) and additional government support to long-range research and development efforts that individual corporations cannot undertake. It means major investment in transportation systems and harbors to help our exports and in urban infrastructure as well as the environment to maintain regional balance and quality-of-life. Investment in infrastructure has to rank equally with investment in defense.

Irving Shapiro, Lane Kirkland and I chair a group of distinguished business and labor leaders presently studying various aspects of industrial policy. The group represents diverse points of view, all of which are being considered. One of the options, which I would personally support, would consist of a tripartite Economic Development Board, along the lines proposed by President Carter in 1980, which was to be chaired by Lane Kirkland and Irving Shapiro. Made up of representatives of business, labor and government, its policy tools could include trade, tax and credit assistance to specific industries or specific regions. The Board could have, as one of its tools, a credit agency modeled after the Reconstruction Finance Corporation of the 1930's. The principles of assistance, whether for industrial investment or infrastructure investment, would be the same: shared sacrifice. Labor would make its contribution through wage, benefit and productivity changes; managements through new investment and job security; creditors and investors through matching commitments to any RFC commitments. Trade, tax and credit assistance would always be conditioned on restructuring contributions by all parties, would be temporary and would be based on expert findings of a resulting viable, competitive industry. Not everyone would qualifty; bailouts for the inefficient are not part of the plan.

I am opposed to a planned economy, and to government-owned industries. I believe that the free market is usually the best market. However, the free market is not always adequate and not always right. The free market would have condemned New York City, Lockheed and Chrysler to bankruptcies that would have been both needless and expensive. Limited use of government credit assistance, extensive restructuring and cooperation by business and labor turned them into viable enterprises, the former the largest urban center with a balanced budget and adequate services, the latter profitable and competitive companies. That is what I am talking about.

Industrial and regional policy can only be part of a sound fiscal and monetary national policy. But it reflects a government's commitment to help absorb the shocks of rapid adjustment, and to maintain social balance. Too many countries competing with us have such a policy in one form or another. It may help us to adjust our training programs and even our educational system to what we need; it must help bring employment to inner city minorities; it should help to take a new look at the costs and possible tradeoffs of fuller employment. We should look at earlier retirement age, inner city school systems that are directly tied into employment opportunities, and some form of national service. Some of these may not work; some may be too expensive. But we have to consider many changes from the status quo.

At this time, I doubt that any individual, any single party, any simple ideology can govern this country. We need a long-range national effort that is bipartisan in nature, not just in appearance, and cooperative in approach; that faces up to the reality of a multi-racial society of widely differing skills and educational levels, and of a nation that is more a continent than a country.

The recovery may well be lasting in which case the present philosophy of government is likely to prevail for some time. Indeed, if I am wrong and if we have long-term steady growth, it should prevail for a very long time, and I should not be sorry. I would then be wrong, but rich, and there are worse things in life than that.

But if I am right, we will face, sooner rather than later, a national debt of $2 trillion, a Third World Debt of $1 trillion, an out-of-control budget and most of our current social and economic difficulties, still prevailing, but on a larger scale.

If there is an alternative, it will be a policy committed to maintain our social gains by promoting economic growth and full employment while able to deliver balanced budgets; a free enterprise system working with an active government to maintain its industrial and regional balance; and a government ready to lead the West to an orderly international financial system and a tough-minded, realistic, unemotional foreign policy.

But none of this will be possibie without the first step of fiscal responsibility. And that is why it is so important that this Committee act wisely and act soon.

Chairman Rostenkowski. Thank you, Mr. Rohatyn.

Mr. Reischauer. You may proceed.

STATEMENT OF ROBERT D. REISCHAUER, SENIOR VICE PRESIDENT, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. REISCHAUER. Mr. Chairman and members of the committee, I thank you for the opportunity to appear before you today. I would like to submit my prepared statement for the record and summarize the major points in that statement for you now.

Chairman ROSTENKOWSKI. Without objection.

Mr. REISCHAUER. My prepared statement deals with three questions. First, will action be necessary to bring down the Federal deficit or will the economic recovery that is under way save you from having to raise taxes and cut spending?

Second, should such deficit reducing measures be taken now or later?

And third, what measures are available to reduce the deficit?

The economy is clearly in a recovery. This economic resurgence has generated optimistic thinking with respect to Federal budget deficits. The Conference Committee on the Budget Resolution revised upward forecasts upon which the Senate- and House-passed resolutions were based, thereby lowering the projected deficit for fiscal year 1984 by some $14 billion.

Secretary Regan in testimony before the JEC, indicated that the administration's new economic forecast will reduce the administration's estimate of the 1984 deficit by some $10 billion. This deficit reestimating activity has led some to hope that a strong recovery in and of itself will substantially reduce the huge budget deficits that have been projected for the late 1980s.

Unfortunately, this hope is little more than wishful thinking. While the current recovery appears stronger than most economists predicted 6 months ago, it cannot be classified as anything more than an average rebound from a deeper than average recession. Projections by Government and private economists suggest only a modest expansion over the next 2 years. Therefore, it would be irresponsible to act as if a spectacular recovery, one capable of significantly reducing the outyear deficits, is under way.

Furthermore, even a spectacular economic recovery could solve only a small part of our deficit problems. An increasingly larger share of the deficits is structural, not cyclical, in nature. In other words, the over $250 billion deficit projected for fiscal year 1988 is not primarily caused by a weak economy but rather can be attributed to our current tax and spending policies.

Thus, the issue is not whether or not the Congress and the President will have to act to bring down the outyear deficits, but rather when and how to act.

With respect to the question of timing it will be tempting to delay action. One reason is that there appears to be no economic imperative to implement deficit-reducing policies immediately. The economy should be able to manage fairly well for several years even with deficits in the $200 billion range. Significant amounts of unutilized resources and capacity are available so the fiscal stimulus inherent in the deficits is not likely to lead to an inflationary surge.

Private credit demands are relatively weak. Therefore, the huge requirements that these deficits place on credit markets need not drive interest rates up significantly. Furthermore, many would argue that the stimulus associated with the deficits is needed to sustain the fragile recovery.

The political imperatives point in the same direction. Action is difficult when there is no consensus regarding what needs to be done to reduce the deficits. Some want to cut the defense budget, while others want to curb entitlement spending. Some feel tax burdens are oppressive already, while others see the tax system as too lenient on the rich. Such a polarization of views would not augur well for developing a deficit reduction program in normal times but in the year before a presidential election the prospects appear hopeless.

While these economic and political factors may delay action on the outyear deficits until after the 1984 elections, such timing could well be too late. For all practical purposes, after the election really means October 1985. It is highly unlikely that a lameduck Congress will want to enact substantial reductions in December 1984. The first months of 1985 will be taken up organizing the 99th Congress and possibly forming a new administration. Under such circumstances, it would be difficult to enact significant policy changes in time for the start of fiscal year 1986 which begins in October 1985. Policies adopted by the new Congress could not be fully effective even by this date. Substantial tax increases, large defense cuts, or major entitlement program changes must be phased in over several years.

Whether the current recovery can be sustained until late 1985 if no action is taken before then to curb the deficits is uncertain. The current recovery is an unbalanced one fueled by a loose fiscal policy and restrained by a restrictive monetary policy. While consumer spending is buoyant, capital spending and net exports are weak. Exceptionally high interest rates are the cause of this imbalance.

The resulting weakness of business fixed investment today will dampen future productivity growth and impair the nation's productive capacity in the last half of the decade. High interest rates have also been a major cause of the 23-percent appreciation of the dollar since 1980, an appreciation that led to sharp reductions in net exports and the loss of sales and jobs.

The unbalanced recovery will be difficult to sustain because as capacity utilization creeps up so will the credit needs of the private sector. The private demands for capital will come into conflict with the Federal Government's need to finance its deficit. Unless the Federal Reserve breaks with its anti-inflationary monetary policy, interest rates will then begin to move up from their already high levels. This could stall the recovery or even bring on the third recession of the decade sometime after the election.

Action now to bring down future deficits could form the basis for a more balanced and sustainable recovery. A reduction in these deficits would give the Federal Reserve room to ease monetary policy. Such an easing would lower interest rates and the value of the dollar, spur capital spending, increase housing starts and car sales and boost exports. To be sure, the deficit-reducing measures would cut into current consumption and reduce employment in the short run. But the restraining effects of any decisions taken now could be delayed if the policies were phased in as the economy strengthened. Over a longer period of time both income and employment should be higher from such actions. The sooner action is taken to reduce the size of the future deficit the better are the prospects for maintaining the recovery as the economy approaches full employment.

With respect to the third question, namely, what specific steps should be taken to bring down the deficit, economists can offer little in the way of insight. Questions such as "How should the reduction be divided between revenue increases and expenditure reductions?" or, "Which taxes should be raised and which programs should be cut?" are fundamentally political questions.

The dimensions of the problem suggest that there will be no easy answer to these questions. If current tax and expenditure policies continue unchanged and the recovery somehow manages to continue, the Federal deficit in fiscal year 1988 will be roughly $250 billion. At least four-fifths of this will be a structural deficit that would not disappear if the economy were operating at full capacity.

The sheer size of the structural deficit makes it clear that no policy prescription with a single focus could do more than make a small dent in the problem. This conclusion holds true even if the objective is lowered a bit and we decide we can live with a structural deficit of 1 percent of GNP, roughly the magnitude of the structural deficits we tolerated in the decade of the 1960's.

To achieve that lowered objective, policy changes amounting to at least $120 billion would be needed for fiscal year 1988. The magnitude of this task suggests that substantial increase and large spending cuts will be required. Both would have a temporary adverse impact on the economy. While employment, prices, and the composition of final demand can be affected by the balance between spending and taxing, and by the choice of which taxes are raised and which programs are cut, these effects are likely to be far less significant than the overall impact that would be exerted by a tighter fiscal policy.

The CBO, the Grace Commission, and other organizations have generated comprehensive catalogs of measures that could be used to reduce the deficit. The revenue options include an income tax surcharge, base broadening, imposition of a consumption and energy tax, and delaying indexation and the other elements of ERTA that have not gone into effect. I feel that a new consumption tax would be difficult if not impossible to enact and implement in the next 5 years and, therefore, this option should be stricken from any list of realistic options.

Base broadening, while always popular in the abstract, is rarely successful in reality. This year's experience with the implementaiton of withholding on dividends and interest, and the popularity of such base narrowing initiatives as tuition tax credits and enterprise zones should make one wary of expecting revenue gains of more than $15 billion from this strategy.

A delay of indexing or a 10-percent individual income surtax would each raise roughly $40 billion by fiscal year 1988. Acceptance of one of these options can be rationalized on the grounds that the personal tax cuts passed by Congress in 1981 have turned out to be significantly more generous than were anticipated when these cuts were approved. This has occurred because the rapid decline in inflation and the severity of the recession have held back nominal wage gains. Slower than expected wage growth has meant that there has been less bracket creep than was forecast in 1981 and, hence, the real tax cuts have been 65 percent greater than expected when they were passed.

If individual income taxes are raised, equity considerations could dictate a comparable increase in business taxes. A 10 percent corporate income surtax would generate roughly $11 billion by fiscal year 1988.

Energy tax options range from oil import fees to broad-based levies on all energy use. Such options could raise anywhere from several billion dollars to as much as $20 billion by 1988.

If you go over the list of revenue enhancing measures I have just mentioned you will find they sum to roughly $75 billion. Considering that was to reduce the deficit to 1 percent of GNP which involved $120 billion worth of tax increases and spending reductions, $75 billion doesn't amount to much more than half of the solution. It also is apparent that the solution is not a matter of choosing one or the other of these tax increases. Rather, it is a matter of taking one from each group.

My prepared statement provides the rough magnitudes of the savings to be realized from some frequently discussed strategies for bringing down expenditures. Briefly, these savings for 1988 are as follows.

About $12 billion for every percentage point by which defense budget authority is brought down; $13 billion for each percentage point by which COLA adjustments in all of the non-means-tested entitlements are brought down; $20 billion for a freeze of nondefense discretionary spending at current levels for the next 5 years; $25 billion for a package of policy changes that would stabilize the medicare trust fund's position over the next 25 years; and $5 billion for each percentage point by which pay increases for both civilian and military personnel are held down.

Whatever specific spending cutbacks are considered, an effort should be made to share the sacrifice broadly. Entitlements, particularly those that are not means-tested, cannot be exempted. Non-means-tested entitlements constitute more than two-thirds of defense, noninterest expenditures and are projected to account for over two-thirds of the growth of this category of spending during the next 3 years. The budgetary importance of these programs requires that they be included in any serious deficit reducing effort.

The concept of a spending freeze for nondefense, discretionary programs is appealing because it is understandable, and it appears, at least superficially, to be fair in that it treats all programs equally. However, a rigid application of this concept at the program level would be inadvisable for several reasons. First, all programs do not have equal priority. This is especially true as time passes and the needs of the Nation change. Second, a freeze for one program may imply a much greater reduction in real service levels than a similar restriction on another. Third, the detrimental effects of a freeze in some program areas may be felt for years, while in other areas they may be speedily reversed. For example, if a Federal pay freeze resulted in an exodus of skilled middle management personnel and a deterioration in the quality of new Federal workers, the repercussion of this could last for decades beyond the period of fiscal austerity. For these reasons, it would be desirable to enforce any spending freeze that was adopted only on broad categories of programs. Budget function or appropriation bill groupings are two options in this regard.

To conclude let me summarize the basic points of this testimony. The current recovery, no matter how strong, will not reduce the size of the structural deficits implied by current tax and spending policies below $200 billion for the late 1980's. If Congress wants to improve the chances of sustaining the current recovery so that the economy can approach full employment, it will have to reduce these structural deficits.

Deficit reducing measures should be enacted sooner rather than later. However, the restrictive impacts on any tax increases or spending cutbacks should be phased in over the next several years to insure that the current recovery is not aborted.

If no deficit reducing actions are taken before the 99th Congress convenes, the economic recovery could falter when private and public credit demands collide. At that point, with unemployment and interest rates rising and car sales and housing starts falling, it will be both difficult and counterproductive to take deficit reducing actions. We will be back where we were a year ago.

In a general sense the specifics of the policies adopted to reduce the deficit are less important than that some concrete steps are taken to deal with the problem. A healthy and growing economy with sufficient capital formation is more important to the long-run defense of the Nation than a percentage point or two in current military expenditures.

Similarly, persistently high rates of unemployment and inflation and a sluggish economy would hurt the low income and dependent populations more in the long run than would a modest and temporary slowdown in the rate of increase of entitlement benefits or a small cut in service levels.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT D. REISCHAUER, SENIOR VICE PRESIDENT, THE URBAN INSTITUTE [1]

Mr. Chairman, I appreciate the opportunity to discuss with this committee the economic and budgetary dilemmas facing the nation.

During the past few months the economic news has improved steadily. Employment has begun to grow at a modest pace; consumer confidence has strenghened at a record rate; retail sales are up strongly; industrial production has increased by over a percentage point during each of the last four months; domestic car sales and housing starts have rebounded to close to their 1979 levels; and there has been no significant rekindling of inflation. Economists, who only six months ago were using words like "anemic," "pathetic," and "weak" to describe the coming recovery, have scrambled to revise their forecasts upward.

The resurgence of the economy has generated some optimistic thinking with respect to the federal budget deficits. The Conference Committee on the First Concurrent Budget Resolution for Fiscal Year 1984 revised upward the January 1983 CBO forecast upon which the Senate-and-House-passed resolutions were based, thereby lowering the projected deficit for fiscal year 1984 by some $14 billion. OMB's mid-session review of the 1984 budget will contain revised economic assumptions that will reduce the administration's estimate of the 1984 deficit. All of this deficit reestimating activity has led some to hope that a strong recovery, in and of itself, will substantially reduce the huge budget deficits that has been projected for the future. If so, the President and Congress could turn their attention to the pleasurable task of maintaining a healthy recovery rather than to the unpleasant job of enacting the revenue increases and spending reductions called for in the first budget resolution.

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[1] For identification purposes only. The views expressed in this statement are those of the author and do not reflect positions of The Urban Institute, its employees, trustees, or sponsors.

Unfortunately, this hope is little more than wishful thinking. While the current recovery appears stronger than most economists predicted six months ago, at this point it cannot be classified as anything more than a rather average rebound from a deeper than average recession. Projections by both government and private economists still suggest a very modest expansion over the next two years and a good deal of skepticism about the continuation of the recovery in the years beyond if no action is taken to reduce the federal deficits. Therefore, it would be irresponsible to act as if a spectacular recovery, one capable of significantly reducing the out-year deficits, is underway.

Furthermore, even a spectacular economic recovery could solve only a small part of the deficit problem. An increasingly larger share of these deficits is structural, not cyclical, in nature. In other words the over $250 billion deficit projected for fiscal year 1988 is not primarily caused by a weak economy but rather can be attributed to our current tax and spending policies. Specifically, the tax reductions called for in ERTA; the buildup in defense outlays; the inexorable rise in Social Security, Medicare, and Medicaid spending; and the interest burden on our mounting federal debt will keep the current $200 billion deficit from declining significantly even as the economy approaches full employment. Thus, the issue is not whether or not the Congress and the President will have to act to bring the out-year deficits under control but rather when and how to act.

It will be tempting to delay action on the deficits for several reasons. First, there appears to be no economic imperative to implement policies immediately. The economy should be able to manage fairly well for several years even with deficits in the $200 billion range. Significant amounts of unutilized resources and capacity are available, so the fiscal stimulus inherent in these deficits is not likely to lead to an inflationary surge. Private credit demands are relatively weak. Therefore, the huge requirements that these deficits will place on credit markets—absorbing well over half of the nation's net savings—need not drive interest rates up signficantly even if the Federal Reserve is able to achieve its announced policy goals. With the abortive recovery of 1980–81 still a fresh memory, the fragility of the current recovery widely acknowledged, and the international economic and debt problems adding another element of risk, many would argue that the stimulus associated with the deficits is needed.

Second, the political imperatives point in the same direction. Action is difficult when there is no consensus regarding what needs to be done to reduce the deficits. Some rail against bloated defense budgets, while others see the problem in terms of runaway spending on entitlements. Some argue that tax burdens are oppressive and discourage capital formation in favor of consumption, while others see the tax code as riddled with unjustifiable and unproductive loopholes favoring upper income groups. Such a polarization of views would not augur well for developing a program of action in normal times, but in the year before a presidential election, when every policy proposal immediately becomes politicized, the prospects appear hopeless.

While these economic and political factors may delay action on the out-year deficits until after the November 1984 election, such timing could be too late. For all practical purposes "after the election" really means October of 1985. It is highly unlikely that a lame-duck Congress will want to return in December of 1984 to enact substantial deficit-reducing legislation. The first months of 1985 will be taken up organizing the 99th Congress and either reorganizing the administration of a re-elected president or forming the administration of a new president. Under these circumstances it will be difficult to enact significant policy changes in time for the start of fiscal year 1986 which begins in October 1985.

Policies adopted by the new Congress could not be fully effective even by this date. Substantial tax increases must be phased in over several years. Unless readiness is to be sacrificed, defense spending cuts can only take effect gradually. Entitlement program changes involve promulgation of new rules and regulations and lengthy review procedures and therefore take months, if not years, to implement. In addition to such technical factors, good policy demands that taxpayers, government suppliers, and beneficiaries of federal entitlement programs be given ample warning and time to adjust to any sharp adverse changes in government policy.

Whether the current recovery can be sustained until late 1985 if no action is taken before then to curb the deficits is uncertain. The current recovery is an unbalanced one, fueled by a loose fiscal policy and restrained by a restrictive monetary policy. While consumer spending is buoyant, capital spending and net exports are weak. Exceptionally high real interest rates are the cause of this imbalance. Many economists believe that current deficits are causing interest rates to be significantly higher than they otherwise would be. Much of the encouragement given to investment through ERTA is being undermined by these high interest rates. The weakness of business fixed investment today will dampen future productivity growth and impair the nation's productive capacity in the latter half of the decade.

High interest rates have also been a major cause of the 23 percent appreciation of the dollar since 1980, an appreciation that has led to a sharp reduction in net exports. American farms and factories have lost sales and jobs because of the fall of exports and the rise of imports. The markets they have lost will be difficult to regain when the value of the dollar declines because new competitors have been created abroad.

The unbalanced recovery will be difficult to sustain. As capacity utilization creeps upward so too will the credit needs of the private sector. The private demands for capital will come into conflict with the federal government's need to finance its deficit. Unless the Federal Reserve breaks with its anti-inflationary monetary policy, interest rates will then begin to move upward from their already high levels. This could stall the recovery or even bring on the third recession of the decade sometime after the election.

Action now to bring down future deficits could form the basis for a more balanced and sustainable recovery. A reduction in these deficits would give the Federal Reserve room to ease monetary policy. Such an easing would lower interest rates and the value of the dollar, spur capital spending, increase housing starts and car sales, and boost net exports. To be sure, the deficit reduction measures would cut into current consumption and reduce employment in the short run. The restraining effect of any decisions taken now could be delayed by phasing the policies in as the economy strengthens. Over a longer period of time, both income and employment should be higher. The sooner action is taken to reduce the size of future deficits the better are prospects for sustaining the recovery as the economy approaches full employment.

Economists can offer little in the way of expert insight into what specific policies should be adopted to reduce the size of future deficits. Taxes will have to be raised and spending curtailed, but questions such as "How should the reductions be divided between revenue increases and expenditure reductions?" or "Which taxes should be raised and which programs should be cut?" are fundamentally political questions.

The dimensions of the problem suggest that there will be no easy answers to these questions. If current tax and expenditure policies continue unchanged and the recovery somehow manages to continue, the federal deficit in fiscal year 1988 will be roughly $250 billion. At least four-fifths of this—some $200 billion—will be a structural deficit that would not disappear if the economy were operating at full capacity.

The sheer size of this structural deficit makes it clear that no policy prescription with a single focus could do more than make a dent in the problem. Those who want to solve the entire problem by closing the tax loopholes (also called base broadening in more refined circles), or reducing the growth of defense spending, or cutting COLA adjustments for entitlement programs, or delaying indexation of the income tax, or freezing domestic non-entitlement spending will need to broaden their focus if they hope to battle the structural deficits effectively. This conclusion holds true even if the objective is lowered a bit and we decide that we can live with a structural deficit of one percent of GNP, which was roughly the magnitude of the structural deficit tolerated during the 1960s. In that case spending cuts and tax increases amounting to at least $120 billion, together with the roughly $25 billion that would be saved in interest costs, would be needed in fiscal year 1988.

The magnitude of the task suggests that both substantial tax increases and large spending cuts will be required. Just where the balance should fall between the two is up to the political process to decide. Both will have a temporary adverse impact on the economy when the tax increases and spending cuts begin to reduce the structural deficit significantly. While employment, prices, and the composition of final demand can be affected by this balance and by the choice of which taxes are raised and which programs are cut, these effects are likely to be far less significant than the overall impact exerted by a tighter fiscal policy.

The Congressional Budget Office, the Grace Commission, and several other organizations have generated comprehensive catalogs and analyses of the numerous strategies and measures that could be used to reduce the deficit. The list of policies to increase revenues includes base broadening, an income tax surcharge, delaying indexation and the other elements of ERTA that have not gone into effect, an energy tax, and a new consumption tax. It would be difficult if not impossible to enact and implement a new consumption tax within the next five years and, therefore, this option should probably be stricken from any list of realistic options. Base broadening, while always popular in the abstract, is rarely successful in reality. This year's experience with the implementation of withholding on dividends and interest, and the popularity of such base narrowing initiatives as tuition tax credits and enterprise zones should make one wary of expecting huge revenue gains from this strategy. A figure of $15 billion by 1988 would be an optimistic but achievable target.

A delay of indexing or a 10 percent individual income surtax would each raise roughly $40 billion by fiscal year 1988. Acceptance of one of these options can be rationalized on the grounds that the personal tax cuts passed by Congress in 1981 have turned out to be significantly more generous than were aniticipated when these cuts were approved. This has occurred because the rapid decline in inflation and the severity of the recession have held back nominal wage gains. Slower than expected wage growth has meant that there has been less bracket creep than was forecast in 1981 and, hence, the real tax cuts have been 65 percent greater than expected.

If individual income taxes are raised, equity considerations could dictate a comparable increase in business taxes. A 10 percent corporate income surtax would generate roughly $11 billion by fiscal year 1988.

Energy tax options range from oil import fees to broad-based levies on all energy use. Such options could raise anywhere from several billion dollars to as much as $20 billion by 1988.

When deciding on which specific revenue increasing measures to adopt Congress should consider the inflationary, efficieny, and equity dimensions of the options as well as the revenue potential and the reactions of the affected individuals and industries.

On the expenditures reduction side the options available to Congress are even more varied and complex. The rough magnitudes of the savings that could be realized from some of the frequently discussed strategies are as follows:

A sustained reduction of one percentage point each year in the growth of defense budget authority would reduce fiscal year 1988 outlays by roughly $12 billion.

Lowering the COLA adjustment of OASDI benefits by one percentage point each year will lower Social Security expenditures by $10 billion in 1988. A similar policy applied to the other nonmeans tested entitlement programs would save an additional $3 billion.

A freeze of nondefense discretionary spending at current levels would reduce fiscal year 1988 expenditures by about $20 billion.

A package of policy changes that stabilized the Medicare trust fund would reduce the deficit in fiscal year 1988 by about $26 billion.

A one percentage point reduction in the annual pay increase provided to federal civilian and military employees would cut spending by roughly $5 billion in fiscal year 1988.

Interest costs on the public debt should decline by fiscal year 1988 by roughly $1 billion for every $5 billion of deficit-reducing measures, if those measures are phased in steadily over the next five years.

Whatever specific spending cutbacks are considered, an effort should be made to share the sacrifices broadly. Entitlements, particularly those that are not means-tested, cannot be exempted. Nonmeans-tested entitlements constitute more than two-thirds of nondefense, noninterest expenditures and are projected to account for over two-thirds of the growth of this category of spending during the next three years. The budgetary importance of these programs requires that they be included in any serious deficit reducing effort.

The concept of a spending freeze for discretionary programs is appealing because it is understandable, and it appears, at least superfically, to be fair in that treats all programs equally. However, a rigid application of this concept at the program level would be inadvisable for several reaons. First, all programs do not have equal priority. This is especially true as time passes and the needs of the nation change. For some programs there may be private sector or state and local substitutes, while for others the federal government may be the only provider. Second, a freeze for one program may imply a much greater reduction in real service levels that a similar restriction on another. Third, the detrimental effects of freeze in some program areas may be felt for years, while in other areas they may be speedily reversed. For example, if a federal pay freeze resulted in an exodus of skilled middle management personnel and a deterioration in the quality of new federal workers, the repercussion of this could last for decades beyond the period of fiscal austerity. For these reasons it would be desirable to enforce any spending freeze that was adopted only on broad categories of programs. Budget function or appropriation bill groupings are two options.

To conclude let me summarize the basic points of this testimony. The current recovery, no matter how strong, will not reduce the size of the structural deficits implied by current tax and spending policies below $200 billion by the late 1980s. If Congress wants to improve the chances of sustaining the current recovery so that the economy can approach full employment, it will have to reduce these structural deficits. Deficit reducing measures should be enacted sooner—preferably this session—rather than later to show the Federal Reserve, Wall Street, and international markets that the nation will not procrastinate until it is too late. However, the restrictive impacts of any tax increases or spending cutbacks should be phased in over the next several years to ensure that the current recovery is not aborted.

if no deficit reducing actions are taken before the 99th Congress convenes, the economic recovery could falter when private and public credit demands collide. At that point, with unemployment and interest rates rising and car sales and housing starts falling, it will be voth difficult and counterproductive to take deficit reducing actions. We will be back where we were a year ago.

In a general sense the specifics of the policies adopted to reduce the deficit are less important than that some concrete steps are taken to deal with the problem. A healthy and growing economy with sufficient capital formation is more important to the long-run defense of the nation than a percentage point or two in current military expenditures. Similarly, persistently high rates of unemployment and inflation and a sluggish economy would hurt the low income and dependent populations more in the long run than would a modest and temporary slowdown in the rate of increase of entitlement benefits or a small cut in service levels.

Chairman ROSTENKOWSKI. Thank you, Mr. Reischauer.

Gentlemen, yesterday's witnesses—and we had quite a few—recognized the fact that there is a problem.

Homebuilders and realtors are predictably worried because of the climbing mortgage rates. They also are worried about whether or not higher rates could well choke off the recovery.

This morning, it is reported that the administration no longer supports their proposed contingency taxes.

We are in a dilemma because there is a feeling in Congress—having passed the budget resolution—that something must be done about revenues. There is also serious discussion about freezing expenditures even from more liberal elements in the membership in the House.

We are political animals. There is no question about that. I agree with your observation that next year will be much more political and that there will not be any interest in looking at revenue increases in a Presidential election year.

The entire world is looking at our deficits, gentlemen. We took a trip with the congressional leadership into the Pacific area, and every one of our trading partners was demanding that something be done about deficits.

Frankly, without the leadership of the President, there are very few profiles in courage on Capitol Hill.

These hearings are being held mainly because I hope to accumulate enough data and public sentiment to build a record in the event that there is a change of attitude. I would agree that interest rates will be higher in the latter part of September and middle October and that there might be a change of attitude.

Mr. Rohatyn, what do you think the Congress should do other than build a record directed at the possibility of enactment of revenue increases. I would introduce the legislation—coupling it with a freeze so that there is a commitment on the part of the Federal Government that spending will not continue to be as generous as it has been.

Mr. **Rohatyn**. Mr. Chairman, I think that the most important thing now, not only for this country but for the world, is lowered interest rates and a cheaper dollar. I don't think you can continually look at a national debt that is going up at 3 or 4 times the growth in the GNP. That is just not a sustainable proposition. Regardless of what the Chairman of the Fed says about monetary targets, the real world still looks upon what happens here, and the difference between income and expenditures and requirements for borrowing. The only way that you will enable the financial markets to lower rates is come up with a package that clearly shows a gradual and steady reduction in the deficit from today's level to $50 billion or so within 3 or 4 years. I think this can only happen with a combination of new revenue measures and something like a spending freeze. The spending freeze is a blunt weapon but it is better than no weapon at all.

Unless you have such a package, I just don't see interest rates coming down sufficiently, not only to continue our own recovery, but also to avoid an explosion somewhere of the Third World debt problem and to enable the dollar to come down a level where we can begin exporting.

I don't think there is any alternative. Waiting for another year is just going to make it worse. I don't think that there be any illusions about that.

Chairman **Rostenkowski**. Would you like to comment, Mr. Reischauer?

Mr. **Reischauer**. I agree with that response. I would also agree with your position that it is very difficult for Congress to do anything while the administration stands on the sidelines and won't play.

It strikes me that the lack of enthusiasm on the part of the administration reflects normal political resistance and the fact that the budget resolution passed by Congress called for rather substantial tax increases and rather minimal spending cuts. The compromise that the administration would like, I think, is a more balanced approach between taxation and spending. How one negotiates that compromise when the administration seems to be unwilling to pursue the very good proposal of Senator Dole for a summit meeting to thrash out these issues, I don't know.

What worries me most is that I don't see the economy providing much in the way of pressure to change things over the next year. I think we can bump along more or less the way we are now with growth slowing from 5.5 percent this year to 4 percent next year, and inflation and real interest rates staying about where they are now. While superficially that scenario may appear to be livable, it is a scenario that digs us into a bigger and bigger hole from which it will be virtually impossible to get out of when pressure does build to act.

Chairman **Rostenkowski**. We talked about consumption taxes and I note in your statement, Mr. Rohatyn, that you suggested an increased tax on gasoline. I have talked to some officials of the automobile industry who informed me that there is a big demand for large automobiles. I do not know how much of an increase that will be with respect to the public demand for larger cars. I do not believe that the automobile industry would build a larger absent public demand for such an automobile. However, it certainly is alarming that we appear to be ignoring the energy crisis that we experienced in the 1970's.

I just feel that everyone should be alarmed with the size of these deficits. All areas of the Tax Code are subject to scrutiny by this committee. Frankly, as chairman of the committee, I am in a dilemma because I think there is a feeling in Congress that we can, should and must do something and that this is the year in which it should be done. However, we do not have our act together—and I am not talking about Members of the Congress but rather about the administration. That is a real problem for us.

Mr. Gibbons will inquire.

Mr. GIBBONS. Thank you, Mr. Chairman.

For both of you, what do you think our Government ought to be doing right now to bring down the artificially inflated value of the dollar in world commerce?

Mr. ROHATYN. Well, I tried to say in my testimony, I think the dollar——

Mr. GIBBONS. Could you speak a little louder, please?

Mr. ROHATYN. I think the dollar is overvalued for two separate reasons. One is because of our very high level of real interest rates in this country as opposed to other countries.

Second, for political insurance. This country is a haven—when the Shah of Iran falls, the dollar goes up because Iranian money comes in. When Mexico goes bankrupt, the dollar goes up because Mexican capital comes in.

Mr. GIBBONS. What should we do though? We all think we know the causes.

Mr. ROHATYN. First, bring the deficit down by combinations of taxes and spending cuts, or spending freezes.

The other thing that I think we should do is to have an international agreement with our main trading partners with the British, Japanese, and Germans, to have a more orderly monetary system and to intervene in the foreign exchange markets when they get out of line—which is where they are today.

Mr. GIBBONS. Have you had luck with our friends down at Treasury on that argument?

Mr. ROHATYN. None whatsoever.

Mr. GIBBONS. Why?

Mr. ROHATYN. Because they feel differently.

Mr. GIBBONS. I knew that but I was hoping you could give me some insight.

Mr. ROHATYN. I think it is a question of judgment. The statement is always made, Mr. Gibbons, that there is no need to intervene in the foreign exchange market if we have convergent policies with our trading partners; if we don't have that it is useless to intervene. But we have convergent policies with the Japanese, the British, and the Germans, and yet these markets get more and more out of line.

There are a lot of serious people who think we ought to intervene in these markets more vigorously, but this Treasury and this administration does not feel that way.

Mr. **Gibbons**. What is the consensus within the financial community on this issue?

Mr. **Rohatyn**. I think the financial community, sir, is very concerned about the dollar both in respect to our trade balance and the way it is hurting our domestic industries, both industries that suffer from imports and industries that are unable to export. It is also hurting many of the countries that have to service dollar debt such as Brazil, Mexico, Argentina, all the countries that are in effect holding a "Sword of Damocles" over our banking system.

I not only think—I know—that the financial community is very concerned about it.

Mr. **Gibbons**. Is that a consensus at the table?

Mr. **Reischauer**. I would agree with virtually everything that Mr. Rohatyn said with the exception that I think it will be very difficult to intervene successfully. In one sense we may regard the dollar as artificially overvalued. But the safe haven factor and high interest rates are very real forces in international money movements. There is no effective way to counteract them without creating other distortions.

Mr. **Gibbons**. Could we collect any penalty for offering that safe haven? We cannot stand this artificially inflated dollar much longer unless we have drastic changes in our economic system.

Mr. **Rohatyn**. I suggested in my testimony that maybe we could consider some variable tariff that would be levied based on exchange rates, deviating from some norm. It is inelegant and fairly crude, and probably to be criticized on all kinds of counts, but I think it is better than doing nothing. At some point we are going to have to think about some new ways to counteract this because we are providing enormous amounts of free insurance to the rest of the world and it is costing us a great deal.

Mr. **Gibbons**. You know, I hate to look like I am passing the buck, I am not. I am asking for help. I know that you gentlemen in the financial community know this; we need leadership and guidance from you.

Thank you.

Chairman **Rostenkowski**. Mr. Conable will inquire.

Mr. **Conable**. Mr. Rohatyn, I understand your message. Incidentally I am skeptical about Bradley-Gephardt. I find it extremely unlikely that Congress would pass a measure of that sort anywhere near the shape that it was as filed. The prime sponsors I think are making a contribution to the dialog about taxes by suggesting this and by pressing it.

I acknowledge, also, that there is only a modest amount of validity to something like the Laffer curve. As we look at the optimum level of taxes, obviously it is going to be affected by the economic matrix in which you are analyzing it. That is going to change from time to time in a volatile economy and a good level of taxes at one point may not be a good level at another point.

I wonder, on average, if you could tell me what you think in the way of appropriate tax levels in a free economy and if we have that appropriately allocated between the generally progressive taxes on the Federal level and the generally regressive taxes on the State and local level. You cannot look at just the Federal tax burden and decide if you got a drag on your economy. Frankly, taxes at that level don't tend to have the same distorting effect if they are more regressive somewhere else.

Yet the growth of State and local taxes has been devastating in terms of its economic impact. That is only partially offset by the deductions we give, for instance, at the Federal level to try to increase the progressivity of the whole system.

Could you give me just a little philosophical musing from your point of view about an optimum level of taxation and the balance between the types of taxes that we have from the various levels of government. Sorry to give you such a big order on short notice but we are talking about, I believe, somewhere around 35 percent of GNP in total taxes, of which 20 percent is Federal and 15 percent is State and local.

How about that?

Mr. ROHATYN. Mr. Conable, I am not sure Aristotle could give you a valid answer on that.

Mr. CONABLE. I am sure he couldn't but maybe Felix Rohatyn could.

Mr. ROHATYN. Let me try to do it.

Mr. CONABLE. Anyway, Aristotle is dead.

Mr. ROHATYN. He is in a better position than I am on that, sir.

Mr. CONABLE. Safer but not better, sir.

Mr. ROHATYN. Mr. Conable, you know first of all the admiration I have for you for the help and the involvement you carried with us when New York City went to the brink of bankruptcy. I think your point about local taxes is very well taken.

We are at least in our part of the country more and more burdened by heavy taxes both at the city and the State level.

These are largely property based or sales based taxes in the case of New York. That is why I came down on the negative side of a notion of large or broadbased consumption tax nationally.

Mr. CONABLE. Clearly that would be very centralizing in a system like ours. We are something quite different from that.

Mr. ROHATYN. I must tell you I feel strongly about this. When I travel around the world and listen to leaders speaking to me in other countries, I find the level of taxation of energy in this country is really scandalously low. And our failures to do anything about it, it seems to me, have brought on some of the massive problems we are facing today.

If we had, had a very stiff gasoline tax right away in 1973 when we had the first oil shock we might not have had such enormous transfers of wealth to OPEC, which then had to be recycled to the Third World. We wound up with our own banking system holding enormous debts that are a significant problem.

So I have a complete conviction that we not only can, but should, tax our consumption of energy much more heavily than it is today.

In terms of corporate income taxes I know there is a great theoretical argument as to whether corporations should pay taxes at all. I find it very difficult if we provide relief for corporations in the areas of regulation, of overall lower tax levels, and of accelerated cost recovery, to see why there shouldn't be some minimum level of taxation that an American corporation doing business in the United States should be able to bear. I believe this very strongly. Whether that level is 25 or 30 percent, how we handle foreign tax credits, et cetera—these are things to be left to the experts.

Third, with respect to Bradley-Gephardt, I know these are complicated issues. But I do think the whole system can stand simplification. I really am tired of making my lawyer and accountant richer than I am by having them file my tax returns for me.

Some simplified version of income taxes is, I think, philosophically possible; one that doesn't necessarily raise more revenue, but is simpler and fairer and caps out somewhere around 30 percent. The numbers that come out of the estimates are probably wrong because the ground is shifting more rapidly than you can cope with. I don't know if that is an answer you can live with, Mr. Conable, but it is the best I can do.

Mr. CONABLE. I can live with it, but I don't know whether I can act on it.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Good to see you again. The Congress appreciates your help in solving our economic dilemmas.

Do you believe the provisions in the Bradley-Gephardt bill provide a fairer system than the existing progressive tax system as it relates to deductions for the upper income and how it provides for the lower income taxes?

Mr. ROHATYN. In general, yes, Mr. Rangel. I am not an expert on taxation, but from what I have read about Bradley-Gephardt, what they are trying, without necessarily raising new revenue, is to simplify the system, to close some of the loopholes, and to put everybody more or less on an even basis.

Now, obviously in my circumstances I will be delighted to have a maximum of 28 percent on the income tax. I don't make use of that many deductions or extraordinary schemes.

If you are asking me, "should people with high incomes be limited to 28 percent?" whether it is 28 or 30 or 32 can be argued, but I do believe that putting everybody more or less on the same basis with respect to deductions, having a simplified system, I think that would be a better thing for this country. Having a low cap could mean that the whole issue of indexing would become moot—if you have a top bracket of 28 or 30 percent, you don't have to worry about indexing.

It might create a lot of unemployment in the legal and tax professions.

Mr. RANGEL. To me, every time we make the system simpler and more equitable, those in the higher income brackets are the beneficiaries. Their deductions seem to prevail, loopholes are created which become incentives to buy houses, borrow money and obtain a variety of other things. But for those people on the lower end of the ladder who don't have the political power to have interest from rent deducted or some provision for sales tax or local tax, whether it is a tax increase or decrease, the percentages don't mean that much.

So while it is a cumbersome system that we are working with, it just seems that at least there is a built-in protection—at least before the last tax bill—for those in the lower income brackets.

Mr. ROHATYN. First of all, in terms of people in higher brackets, you can handle that by the way you handled the deductions. I would perfectly accept the notion of the much stiffer approach to deductions with lower ceilings on income. You can even it out that way.

The most important thing for everybody, Mr. Rangel, is to get to the subject of interest rates and growth in the economy and sustained growth.

Mr. RANGEL. Thank you.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Rohatyn, I have two questions I want to ask you. I notice in your statement you said tax increases and spending cuts should go along together. That we ought to reduce the deficit down to about $50 billion in the fourth year. You also said the Fed could ease up on the interest rate situation and lower that 2 or 3 points. You say a 6-percent prime rate could be the result.

Do you think that is going to happen? Is that just a pie-in-the-sky observation of yours or are you recommending it?

Mr. ROHATYN. Well, I don't think it is a certainty, Mr. Pickle. I don't think it is pie in the sky. I would be opposed to any approach that forces the Federal Reserve to do anything, because I think the system is working pretty well as is. If, as a result of actions both by the executive and the Congress, there was a clear and certain reduction in this deficit of the magnitude that I am talking about, namely to bring the deficit by a package of spending cuts and revenues to $50 billion or less within 3 or 4 years, then I think you would have this reduction in interest rates.

Mr. PICKLE. You are being theoretical, you are not recommending they lower 2 or 3 more points, but——

Mr. ROHATYN. Beg your pardon, sir?

Mr. PICKLE. I said you are just being theoretical, that it could be done, but you don't think it will be done and you are not recommending it?

Mr. ROHATYN. I am recommending it——

Mr. PICKLE. You are just musing about it.

Mr. ROHATYN. I am certainly recommending it. I am recommending that if there is a summit as Senator Dole recommended, involving the budget that includes the President and the congressional leadership that it include the Chairman of the Fed. So that if you make a deal you have somebody there who can carry it out for you.

Mr. PICKLE. Well, as one member I would like to know if you think we could lower the prime rate to 6 percent and knock off 2 or 3 percentage points on our interest rates.

Mr. ROHATYN. I do.

Mr. PICKLE. I want you to tell me how to do it and I will take it personally to Mr. Volcker and ask him to consider your views.

Mr. ROHATYN. If these actions are taken the markets would do it for you.

Mr. PICKLE. You made a statement in your testimony that you thought the IMF has to be enlarged more than is now recommended. The President recommended an additional $8 billion for this IMF fund.

It is questionable whether he is going to get the $8 billion. The odds are the Members haven't swallowed that recommendation yet. You are recommending it be more. How much more?

Mr. ROHATYN. I didn't recommend it to be more, Mr. Pickle, I said I think more money will be needed than even the request presently made.

Mr. PICKLE. You said it will be needed, so you are saying it ought to be increased to more than $8 billion?

Mr. ROHATYN. No, I didn't say that. I said there is going to be more money needed to get economic recovery in the rest of the world. I don't think we should do this alone. I think we should do it with other countries with the same interests we have, the Japanese, Germans, British.

All I am saying is I think it is an illusion to think that the amount of money that we are increasing the IMF by is going to be enough to handle what I think is going to be needed in the rest of the world.

Mr. PICKLE. Well, we are going to be facing this decision within the next day or two, and it bothers a lot of us in the House, because, as of December 1982, three Latin American countries, Mexico, Brazil, and Argentina, owed the United States more than $70 billion.

Now, are we going to pump money into these countries so they have more to spend and hopefully pay back what they owe us?

It just seems to me we have the Third World debt situation that is now frightfully large, and it could topple the whole international monetary system if something isn't done.

Your answer is to pump a few more dollars in that reserve. A lot of us have second guesses about that.

Mr. ROHATYN. I am sure it is a very unpleasant vote, Mr. Pickle, but the reality is we are prisoners of the Third World debt. I would support the IMF contribution being asked for, although I realize it is no cure, and it is very unpleasant.

Mr. PICKLE. I would have to take a second look at the rest of your testimony, then.

Chairman ROSTENKOWSKI. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Gibbons, a while ago, was talking about the exchange rate, and I share his concern with the overvaluation of the dollar. I also believe that if we are going to have a sustained recovery, we must have steady and steadily increasing exports. If we are going to achieve that, we must have stability in the exchange rate.

So I was very interested in your proposal of a tariff tied to exchange rates. But, Mr. Rohatyn, about a year ago, I had gone to my staff and told them to develop what I called an exchange rate equalization tariff, along the lines that you recommended this morning.

They spent a fair amount of time looking into it, and came back and told me that it was virtually impossible to achieve.

So I would love to have you tell my staff how they are wrong and how this can be achieved in a practical way, because I think that if we could achieve it, it would go a long way toward solving some of our long-term economic problems.

Mr. ROHATYN. Mr. Schulze, I want to assure you I didn't steal your briefing papers.

Mr. SCHULZE. No, no, I don't hide mine; everybody is welcome to them.

Mr. ROHATYN. I would be happy to talk to your staff. As I say, it is not a terribly elegant way of doing things, but it is better than nothing, and if people want to do it, there are ways to do it.

Mr. SCHULZE. One of the criticisms was that somebody had to play God.

Mr. ROHATYN. Of course.

Mr. SCHULZE. And say this is the rate and this is what your currency is worth.

Mr. ROHATYN. I know.

Mr. SCHULZE. And that is it. Whether you like it or not.

Mr. ROHATYN. You don't have people playing God. You can have people with judgment and you can have people looking at averages over long periods of time. It is not perfect.

On the other hand, we have a whole system based on people's judgments, beginning with the Supreme Court.

Mr. SCHULZE. You have given thought to this, and you think in the long run it can work.

Mr. ROHATYN. I have given some thought to it, and I think, under certain circumstances, it can work. Under other circumstances, even a serious discussion of our thinking about this in this country might have a very salutary effect, and encourage other countries to begin to cooperate on different aspects of the problem.

Mr. SCHULZE. It might be a gentle club is what you are saying?

Mr. ROHATYN. At least an incentive to negotiate.

Mr. SCHULZE. An incentive tool.

I am very interested in that. I had kind of given up on it, but if you have further thoughts or have anything down on paper, I would be happy to do so.

Mr. ROHATYN. Thank you.

Mr. SCHULZE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

It is good to see you again, Mr. Rohatyn, and Mr. Reischauer.

I want to ask you, Mr. Rohatyn, if we could afford to do a $12 billion tax increase of some form this year, which is our instruction from the Budget Committee, without hurting the economy—you have suggested, of course, some consumption taxes.

Do you think the $12 billion in fiscal year 1984 would be dangerous for the economic recovery?

Mr. ROHATYN. No, not for 1984. As long as it were packaged with some spending reductions, so that it would not simply be an open-ended exercise.

I think it would depend where you taxed. As I said, if you taxed energy, I don't think you would have the slightest drag on the economy. $12 billion, if it were part of the program that would build up to somewhere between $50 and $75 billion over the next 4 years, and if it were packaged with a spending freeze or specific reductions in entitlement and military programs, I think that is perfectly sustainable.

Mr. DOWNEY. Dr. Reischauer?

Mr. **Reischauer**. I think $12 billion is perfectly achievable and good policy for 1984.

Mr. **Downey**. We finished up with the President's tax cut, and it is not going to be changed. In retrospect, was the 5-year tax cut a good idea, bad idea, in your opinion, now?

Mr. **Rohatyn**. You know, retrospects are a luxury that I don't indulge in.

Mr. **Downey**. Let me ask you specifically about ACRS. As modified by TEFRA, do you think that is about right, too generous, less than generous for depreciating capital?

Mr. **Rohatyn**. As I indicated in my testimony, we may have gone a little too far on that, in winding up with very little tax paid by some major corporations, although clearly the need for investment is there, and the need to refurbish our plant is there.

I still believe that a lot of our investment in this country is driven by consumer spending and if the economy recovers and interest rates are down and the consumer is spending we will invest in plant and equipment.

It is very, very difficult to tell people "we are going to cut your benefits" and "we are going to tax your gasoline," or whatever, while at the same time we have major businesses in this country paying little or no tax.

Mr. **Downey**. It is a matter of equity.

Mr. **Rohatyn**. Yes.

Mr. **Downey**. Dr. Reischauer, can you give me your views about ACRS?

Mr. **Reischauer**. As modified by TEFRA and given inflation rates we expected, I would say it was not an excessive tax reduction. Given the actual reductions in the overall inflation rate, there would be no harm in imposing a slight surtax on businesses if we were going to do it on personal income taxes, too.

I think the new inflation forecasts have made both the business tax cuts and personal income tax cuts much larger than we anticipated in 1981.

Mr. **Downey**. Let me ask you quickly about capital gains. You suggest that we could increase the corporate income tax somewhat or have a minimum tax and do something on the capital gains side.

Could you give me a number you would like to see?

Mr. **Rohatyn**. On the rate for capital gains, we are probably about right. On the holding period, you might want to go down a little.

Mr. **Downey**. Six months?

Mr. **Rohatyn**. Something like that.

Mr. **Downey**. Dr. Reischauer?

Mr. **Reischauer**. I have no comment on that.

Mr. **Downey**. Let me ask you, lastly, a follow-up question that Mr. Schulze expressed interest in and this was the normalizing of exchange rates. You have an example and I realize this is just tentative on your part, but if somebody declares this is the rate of the yen based on historical experience or whatever, what would happen if the yen went below the level or above the level that you set?

Would there be a premium for them?

Mr. ROHATYN. No, I don't think so. If it went below the level that it was supposed to hit, I wouldn't propose a refund.

Mr. DOWNEY. OK.

Mr. REISCHAUER. Could I add a note of skepticism on this plan without knowing any of its details? Let's suppose we did have some exchange rate normalization tariff or whatever the appropriate label would be. What would that have done to us in the last few years?

Well, the value of the dollar would have changed from the standpoint of imports. We would have had fewer imports. At this point this would be good for American industry, and would cause the recovery to be a little stronger than it is. But we would be up against the problem of the conflict between public and private credit demands a lot sooner.

In addition, if some kind of tax were put on the inflow of capital from countries that were seeking security and safety, less of that capital would have flown into this country. That would mean that, everything else being the same, we would have less capital available to finance the debt and interest rates would be higher than they are now.

I don't see that this is a solution to the basic problem that Congress and the administration are facing right now. It is a wishful idea. If only the dollar would depreciate relative to our major trading partners things would be better—the question is, why is the dollar so high?

Mr. ROHATYN. I would like to clarify one thing, because you are absolutely right. I don't propose to apply this to capital transfers. This would only be to goods shipped. I don't claim any greater virtue for this proposal other than it is better than no proposal at all.

I would much prefer to see a coordinated exchange rate approach by the central banks.

Mr. REISCHAUER. Barring the fact that the tariff on imports was provided as a subsidy to exports, I don't see that it would do a lot for the American farmer selling grain abroad or Caterpillar Tractor or any firm like that, either.

It is a very imperfect tool.

Mr. DOWNEY. Thank you.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Rohatyn, you were talking about real interest rates and about your concerns. That is the difference between the market interest rate and rate of inflation, the real interest rate, which has risen in the last several years.

I think your point was that uncertainty about the future, and inflation expectations and so on, is keeping real interest rates higher than it ordinarily would be.

To what or how do you explain the real interest rates for short-term loans, 60- and 90-day loans, where there is certainly no uncertainty about the problem of inflation? As you know, the short-term interest rates are unusually high in this country today.

The real interest rate on short-term notes can not be explained by uncertainty of the future. How do you explain the short-term rates?

Mr. ROHATYN. There are a lot of great experts and brilliant people who sit around every day trying to figure that out, and I am not saying this jocularly. I think that is a very, very valid question.

I think the only way you can explain it is by really demand and supply of cash moving in the economy. I think there have been a number of actions taken that have raised the overall level of interest rates in this country.

What was done to solve the savings and loan problems, for instance, permits the savings and loans to pay higher rates.

When the banks are allowed to compete in the money market business and begin to buy money at high interest rates is another. The fact that you have $600 or $700 billion out there in the Third World that isn't coming back, that the money coming back to the banking system is less; plus the margins they are having to pay because of the Third World loans—that affects rates, too.

I can't identify any one.

Mr. DORGAN. No one mentions the buffalo mentality of pricing money. Is there some influence of price leadership, influenced by the largest to determine what the rates are? That becomes the rate then.

Mr. ROHATYN. I am inclined to think that there are real market demands and changed elements in the financial structures that are doing this.

Mr. DORGAN. Let me turn for a minute to the subject of the IMF. Congressman Pickle talked about the IMF. I have spent a lot of time studying this issue. The more I study and the more I learn, the more convinced I am that it would be a serious mistake to vote for the $8.4 billion.

Mr. Weintraub from the Joint Economic Committee wrote recently about the consequences if we didn't provide the funding. The banks want us to believe it is a debt bomb. I think it is a debt mess, not a bomb.

If we provided the money upfront, it is going to be a take-the-money-and-run situation. Don't you think it is very important at the front end that a correction of the debt be absolutely required, that the debt instrument between the banks and the countries that receive the money in most cases are instruments that need correction?

If that correction comes, isn't that going to avert the need for this funding in large part?

Mr. ROHATYN. I think the correction has to come, and as I testified, I would strongly support and urge a major restructuring of a lot of this debt.

On the other hand, unfortunately, you are faced with a question of this IMF increase long before you can get around to restructuring a lot of this debt. As I said earlier, I am sure that it is not a pleasant vote and I don't think you can be sure whether you are really solving a problem, but I would think the risk from voting this down is significant in terms of impact on the markets.

Mr. DORGAN. In lieu of providing $8.4 billion, why could the gold that the IMF holds not be used as collateral for loans?

Mr. ROHATYN. I think the $8.4 billion is symbolic of U.S. participation and leadership in this exercise. If you walk away from it, it is going to be troublesome.

Mr. DORGAN. The answer is symbolism. My concern is that the banks have cried fire in the theater on us and have created the alternatives for discussion here in town. I just find that to be unacceptable, and I was interested in your testimony.

You have made some very important points. We happen not to agree on the IMF issue, but I appreciate your testimony.

Mr. ROHATYN. Thank you.

Mr. DORGAN. Dr. Reischauer, I appreciate your testimony as well. It was very thoughtful.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to thank both of our witnesses. I think your testimony has been absolutely outstanding.

I get a real sense of alarm from the testimony of both of you gentlemen, and I think if you would go beyond the sounding of the alarm to consider what the chances are of any action by Congress and the President over the next 1½ years that you might well convey a sense of despair as well. I certainly have had that myself.

We are under instructions from the House budget resolution to raise revenue of $12 billion in 1984, of $15 billion in 1985 and $47 billion in 1986. What message would we be sending to financial markets if this committee and the House failed to meet that requirement of the House budget resolution?

How serious would the impact be?

Mr. ROHATYN. I don't want to sound disrespectful, because I know the problems you face up here. But I would say to you, sir, that I think the financial community at large really has given up on the budget process here. We just don't think it is going to happen.

Anything that you did that indicated there was even the possibility for the process to go forward, even with all the imperfections that come with it—any motion toward cost control and revenue raising and at least some organized progress toward reducing deficits of significance that is not just cosmetics—would send a dramatic signal to the financial markets and to the business community.

Especially since, and I say this with all due respect and without any underestimation of your problems, there is very little expected out there at this point.

Mr. PEASE. Dr. Reischauer?

Mr. REISCHAUER. I think that if Congress did not act within the next 8 months, there would be a perception in the private sector that nothing was going to happen until economic events forced another crisis.

Mr. PEASE. Thank you.

Mr. Rohatyn, on page 8 of your testimony, you indicate that the minimum corporate tax would be essential and you say that the corporate income tax is clearly justified on grounds of equity.

But then you go on to talk about the possibility of encouraging capital formation by lowered capital gain rates.

I am a little concerned about the equity. The maximum rate is now 20 percent on capital gains. What about the equity for the average citizen who these days is working in a factory or wherever, and finds that by the sweat of his brow he is earning money and paying 28 or 32 percent or more at the margin, whereas people who are investing their money are paying only 20 percent?

Does that bother you?

Mr. **Rohatyn**. My testimony may not have been terribly clear. I think we have lowered capital gains taxes to the level that one needs to.

As I indicated to Mr. Downey, if we were to do anything in the capital gains tax area, I would suggest looking at the holding period. But I do think that some level of corporate taxation is justified.

I am not saying that it has to happen, but it seems to me that as part of a package that involves some energy taxes—which are consumption taxes—and some simplification of the income tax such as Bradley-Gephardt, you could also deal with a certain level of income coming from business without hurting the recovery or investment.

Mr. **Pease**. Thank you.

I am intrigued with this variable tariff idea of yours. Do you feel that would be a violation of the GATT if we enacted such a provision?

Mr. **Rohatyn**. Well, I think that if you find a group of able legal experts in the international area, you might be able to weave your way in and out of that problem. I think, clearly, that yes, it is a problem.

As I have said many, many times, I don't view this as a perfect answer. On the other hand, I don't believe there are any perfect answers, and I believe the status quo is an untenable proposition. If the status quo continues, especially if we have a recovery and start sucking in large amounts of foreign imports, the pressure is going to be hard to resist up here for protectionism.

I would like to approach it in a more gingerly and flexible and targeted way.

Mr. **Pease**. Thank you very much, I really enjoyed your testimony and appreciated your testimony.

Chairman **Rostenkowski**. Mr. Hance will inquire.

Mr. **Hance**. Chairman Rostenkowski made a speech about the provisions of the 1981 bill that have not gone into effect, we had passed legislation that would keep those from going into effect would be an alternative. What would both of you think about the possibility of postponing all provisions that go into effect in 1984 and beyond?

Say we postpone them for 4 years and it is just starting in 1984, and we postpone to 1988 and for 2 years we postpone all COLA's on entitlement programs?

Mr. **Rohatyn**. I leave it to you.

Mr. **Reischauer**. I was looking for Socrates.

The first element of that, which would be a 4-year freeze of the 1981 tax provisions that have not gone into effect, I would look upon as about the right size package and a responsible act.

The idea of freezing all COLA adjustments for 5 years, however, I think——

Mr. **Hance**. For 2 years. Even for 4 you——

Mr. **Reischauer**. But that is an unequal proposition.

Mr. **Hance**. No question about that.

Mr. **Reischauer**. On one side, you were talking about delay of a reduction in tax burdens and on the other side, you were talking about a decrease in benefit levels that lasts forever.

Now, for some programs I might go along with that proposal. But when we are talking about programs like SSI and food stamps, I would not, because the recipients of those programs are hanging on the margins of survivability.

Mr. **Hance**. We would exempt means-tested programs, though.

Mr. **Reischauer**. Social security, while it goes to a lot of fairly average and well-off elderly people also is a very important source of support for the very low-income elderly. I would rather see those proposals which index the non-means-tested entitlement programs by the CPI minus 2 percent or minus 1 percent.

Mr. **Hance**. And what the realtors——

Mr. **Reischauer**. And allow that restriction to stay in effect for 4 years rather than an absolute freeze for 2 years. But these are judgment calls for Congress to make.

Mr. **Hance**. You are like a lot of Members of Congress, when it comes to pick and choose, everybody has a protected turf. You go back home and tell the farmers you are going to freeze the target price, they get mad, but if you freeze everybody, you get by with it.

That is the problem. AFL–CIO shows up yesterday and they said, "We don't want you to cut spending." The Chamber of Commerce shows up and says, "Don't raise taxes." They would be for cutting taxes.

But the reality is somewhere in between, of course.

Mr. **Rohatyn**. I don't think I could answer that question, Mr. Hance, without a lot more study that I just have not done.

Mr. **Hance**. The realtors yesterday testified for 3 percent below CPI on non-means-tested COLA's and they also testified that on the indexation of taxes, that goes into effect in 1985, that it be 3 percent below CPI and do that for 4 years.

Mr. **Rohatyn**. I think it is a pretty good idea.

Mr. **Hance**. Both sides have to give.

Mr. **Conable**. Will the gentleman yield?

Mr. **Hance**. I yield.

Mr. **Conable**. You realize that while it provided parity, $48 billion of the $60 billion in saved expenditures comes from social security. If you believe that we are going to revisit social security here, you will also believe in the tooth fairy.

Mr. **Rohatyn**. I may believe in the tooth fairy, and I may believe it is a good idea.

Mr. **Conable**. Fine, just so you understand the political context in which the proposal is put forward.

Mr. **Rohatyn**. I understand.

Mr. **Hance**. The problem with that, you know it is awfully hard to go home and tell people that you voted to give Bob Hope a 7.4-percent cost-of-living adjustment in social security. They have a tough time realizing that everybody getting social security is in poverty.

Mr. **Rohatyn**. I just think if you get the process going, so that you get a steadily growing economy, get reasonable interest rates and keep inflation down, you will have a much easier time dealing with these COLA-related problems, and with people's insecurity with respect to the inflationary rates that have existed over the last 10 years; you might be able to bring it under control.

Mr. Hance. So that would help take care of itself.

Mr. Rohatyn. I would hope so.

Mr. Hance. Thank you, Mr. Chairman.

Chairman Rostenkowski. Mr. Jenkins will inquire.

Mr. Jenkins. Thank you, Mr. Chairman.

I want to thank the panel for their testimony. I only have one question.

Mr. Rohatyn, let me give you a couple assumptions. Assume that spending proceeds at about the same levels as under the present resolution, and then assume that we will not raise $12 billion in additional revenues or any additional revenues from an increase in taxes.

Looking at the calendar years of 1985 and 1986, where do you think we will be, from an economic standpoint? I understand you will have to make your own assumptions about the recovery and that sort of thing between now and then.

Just assume we don't raise any taxes and that we continue to spend at about the present rate with no additional reductions. Where do you think we will be in 1985 and 1986?

Mr. Rohatyn. I agree with my colleague here, I think you will muddle through. I think that for the time being, there is enough strength in the economy to push it along. I think interest rates are likely to go up a little bit.

I think your big unknown, the big landmine in that, is not domestic; it is overseas. It is what happens to one of these Third World countries that are having trouble servicing their debt and where between now and 1985, Brazil or Mexico or Argentina or one of these has to declare a moratorium on its debt with the resulting problems on the banking system.

I would think it is much more with an eye to that problem that Mr. Volcker was talking about easing his monetary targets yesterday, rather than the feeling that there is a big danger of aborting the recovery here if interest rates go up a little bit.

Mr. Jenkins. So you think we will be about the same?

Mr. Rohatyn. About the same, yes, absent some kind of serious problem abroad which could abort this recovery with a lot more serious consequences.

I think that is unpredictable. I don't think it is a risk worth running.

Mr. Jenkins. Thank you.

Mr. Reischauer?

Mr. Reischauer. I would predict that sometime late in 1985, Chairman Volcker is going to be a very worried and nervous man because he will be sitting on a situation where interest rates are beginning to rise, and he can see them rising in the future unless he eases up on monetary policy. But if he eases up on monetary policy, he will validate inflationary pressures and we have a surge in the CPI. Yet he realizes that if he holds tight, he is going to cause the international problems that we have heard about today to worsen. There will be a "How can we muddle through this situation?" dilemma.

Mr. JENKINS. On the present course, then, you think in late 1985 there will be an increase in interest rates, or in the alternative, a rather substantial increase in inflation. Is that correct?

Mr. REISCHAUER. Yes.

Mr. JENKINS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Flippo will inquire.

Mr. FLIPPO. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. I want to thank you both for your counseling and good advice. Of course, politics is the art of the possible, although many people would have agreed with you about the large gasoline tax, knowing what special interests are in Washington, many things we would like to see happen couldn't possibly happen.

Today, we have an effective tax rate on insurance companies of less than 1 percent. We have an effective tax on banks of 2.3 percent. It would be utopia to think there would be a minimum income tax on some of these institutions of 25 or 30 percent.

Unfortunately, special interests being what they are, make it very, very difficult, and our tax expenditures are extremely high.

A fair tax, which you propose, would perhaps get at $200 billion worth of tax expenditures that we currently have in the Tax Code.

I would like to see the locusts descend on Washington if we try to tax corporations as we should, taking away the tax expenditures that we would like to take away from some of the areas. Do you have any advice or comment?

Mr. ROHATYN. Mr. Guarini, I am a political neophyte.

Mr. GUARINI. We all are in a sense.

Mr. ROHATYN. On the other hand, when we—the only education I had was in New York City, which I suppose you could say is a liberal education. But we did lots of things that were supposedly impossible politically, because the city was going bankrupt. One day, the country is going to go bankrupt and you will find a lot of the politically impossible things are going to be doable.

Mr. GUARINI. We go from crisis to crisis.

Mr. ROHATYN. I think you will probably do that, yes.

Mr. GUARINI. We learn the hard way.

Mr. ROHATYN. The question is whether you can catch the last crisis before it gets out of hand.

Mr. GUARINI. I agree with you. We are headed into disasterous waters. Of course, what concerns me is the world banking problem. We can give an extra $8.4 billion to IMF, but I don't see how the money will ever be collected.

We can extend the term of the loans. But it is like throwing money down a drain. I just wonder whether you think a banking moratorium on world banking would be better than perhaps giving the money to the countries which would in turn really bail out the banks.

What we are really doing is helping our banks from sustaining the losses. They are buying the Eurobonds because they can make more money buying Eurobonds than they can by buying Treasury notes or by investing the money in this country.

So, they took a bigger gamble.

That is the only business I know that can come to the Government and say, "Bail us out, we have a problem." Is this fair? Is there an answer to this? Is there a comment that you have on this?

Mr. **Rohatyn**. The only answer is, as I tried to indicate earlier, sir, that I am fully alive to the problems of the IMF vote and of your problems with it, and the imperfections of the system and the need to do something on a major scale to make it better.

On the other hand, the only thing I can tell you is I think voting for the IMF contribution is less dangerous than voting against it. It is one of these choices of pain or agony.

Mr. **Guarini**. But there is no light at the end of the tunnel, is there?

Mr. **Rohatyn**. I think there is very little light at the end of the tunnel. But if you don't make this contribution, I think this tunnel is going to close in on you pretty rapidly.

Mr. **Guarini**. You, however, propose a Reconstruction Finance Corporation. Do you see a possibility of Government and labor and management getting together and starting to work in the unison that they should, so that our national productivity gets to a level it should?

Mr. **Rohatyn**. Sure, it happened in the case of Chrysler. I think it happened in the case of New York City.

Mr. **Guarini**. But, suddenly, there are wage demands the first day the profits are announced.

Mr. **Rohatyn**. There will have to be tradeoffs. There will always be.

Mr. **Guarini**. Is there a mechanism we can put into play that you think could develop a better relationship instead of an antagonistic relationship between the three components?

Mr. **Rohatyn**. Yes, I think so. I think the Economic Development Board we have been talking about, some version of a RFC or industrial development bank or other capital would be conditioned on labor and management both making contributions. I think we are getting there. It may not be tomorrow, or next year or it may not be the year after, but we are going to get there.

I don't think there is any alternative to it.

Mr. **Guarini**. It is a long, painful process.

Mr. **Rohatyn**. It is a long road.

Mr. **Guarini**. Thank you very much, sir.

Mr. **Jenkins** [presiding]. If there are no further questions, I want to thank the panel for their testimony.

Our next witness is Mr. Theodore Brophy, cochairman of the Business Roundtable.

Mr. Brophy, if you would come to the witness table.

STATEMENT OF THEODORE F. BROPHY, COCHAIRMAN, THE BUSINESS ROUNDTABLE, CHAIRMAN, TAXATION TASK FORCE AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GTE CORP.

Mr. **Brophy**. Thank you, Mr. Chairman.

Mr. **Jenkins**. We are delighted to have you before the committee again. Your entire statement will be made a part of the record and you may testify as you see fit.

Mr. **Brophy**. Thank you, Mr. Chairman.

Thank you, distinguished members of the committee, my name is Theodore F. Brophy, I am chairman and chief executive officer of GTE Corp. I serve as cochairman of the Business Roundtable and chairman of its taxation task force. I appreciate the fact that you will incorporate my full statement in the record.

The roundtable has for some time been deeply concerned about the high level, structural nature, and trendline of projected Federal budget deficits. They will siphon off large amounts of private capital from the financial markets, cause interest rates to rise, and stifle economic recovery.

There is general agreement that a strong recovery is now underway, but its sustainability should not be taken for granted. Moreover, the recovery has been very uneven so far. Though residential construction and consumer spending for durable goods have rebounded strongly, investment in new plant and equipment is still near its recession low and exports of goods and services are still declining.

This country needs a well-balanced recovery, one that will foster capital investment as well as increased consumption to restore U.S. competitiveness in the world marketplace.

Although a strong economic recovery will help close the cyclical portion of the deficit gap, it will not close the structural portion. Nevertheless, our first order of business should be to assure that the recovery stays on course.

The Roundtable believes that the major emphasis for closing this structural deficit gap must come from reductions in the growth of Government spending. Toward this end, we issued a policy statement during the first quarter of 1983 citing five areas where essential savings could be achieved on the expenditure side of the budget, namely: defense; social security; freezing most nondefense discretionary programs for 12 months; limiting cost-of-living adjustments for non-means-tested entitlements; and additional long-range savings in medicare.

Unfortunately, only the first two areas have been addressed.

Until adequate restraint is placed on the spending side, we believe that revenue raising should not be considered. Accordingly, the Roundtable does not support a $12 billion tax increase for fiscal year 1984, as called for in the budget resolution.

Now that a recovery is underway, the single most important issue facing the economy is the size of the projected budget deficit.

Exhibit III of my written testimony presents a comparison of three recovery intervals since 1960. The exhibit presents a clear picture of the underlying trends, and highlights the problem that we now face. Taxes as a percent of GNP in the present recovery are roughly in line with the two earlier recoveries. Federal spending as a percent of the GNP, on the other hand, has ratcheted upward substantially compared to the experience of earlier recoveries.

The deficit as a percent of GNP has risen to record levels. Moreover, in the present situation, the deficit is projected to remain unacceptably large even after 3 years of recovery. This suggests that the structural deficit is expanding rather than contracting.

It is important to recognize that it is the structural deficit that is the real threat as the recovery progresses. This large structural deficit will distort the economy in two ways: It will tend to crowd out private capital investment in new plant and equipment, and it will cause interest rates to rise.

Higher interest rates will increase the value of the U.S. dollar in foreign exchange markets which tends to depress exports and favor imports.

Large deficits also increase the risk of an early end to the recovery by placing a greater burden on monetary policy as the only instrument for controlling inflation.

Because the spending side has not been properly addressed, the Roundtable believes that it is premature to discuss initiatives to increase revenue.

If the growth in spending can be sufficiently restrained, the roundtable will be prepared to work with the Congress to identify new long-term revenue sources that may be needed in the 1986–88 timeframe to meet a goal of eliminating deficit financing and achieving a balanced budget.

The complexity of the tax system and its bias against savings and investment, as opposed to consumption, dictates thorough review by the Congress before any major revisions are initiated. Since the future pattern of jobs, productivity, and real incomes are at stake, it is essential that Congress exercise the utmost vision and care in any major restructuring of the tax system.

Our organization would certainly hope that any major structural revisions to the tax code in the future would: increase the flow of funds for savings and investment; strengthen U.S. export trade; provide a less complicated set of tax rules; and plan for a smooth transition from the current system.

I realize that this committee is studying the nature and timing for revenue-raising legislation as a result of reconciliation instructions. We do not believe that the budget problems facing this Nation can be solved on the revenue side without first bringing the expenditure side under control. Unless the Congress can achieve some degree of control over spending, it will be extremely difficult for our economy to finance enormous deficits and, at the same time, provide the substantial amounts of capital that is needed to support future economic growth.

That concludes my prepared remarks. Thank you very much.

[The prepared statement follows:]

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GTE CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE

SUMMARY

The Roundtable has for some time been deeply concerned about the high level, structural nature and treadline of projected federal budget deficits. Our organization has long been convinced that unless these deficits were placed on a decisive downward slope, they would siphon off large amounts of private capital from the financial markets, cause interest rates to rise and stifle economic recovery.

An economic recovery is underway, but its sustainability should not be taken for granted. Moreover, the recovery has been very uneven so far. Residential construction and consumer spending for durable goods have rebounded strongly, but investment is still near recession lows and exports of goods and services are still declining. These two sectors are critical to the long-term health and viability of the recovery. The Roundtable is seeking a well balanced recovery, one that will foster capital investment which is essential for high productivity and job creation. Consumption spending alone cannot provide the framework for long-range growth.

The economic recovery will go a long way toward closing the cyclical portion of the deficit gap. However, even with a strong recovery we will still be left with a very substantial gap between estimated revenues and expenditures—the so-called structural portion of the deficit. The Roundtable believes that the major emphasis for closing this remaining gap must come from reductions in the growth of government spending. Until adequate restraint is placed on the spending side, we believe that revenue-raising should not be considered. Accordingly, the Roundtable does not support a $12 billion tax increase for fiscal year 1984, as called for in the budget resolution.

The Roundtable has tried to maintain an open mind during the past two years toward the subject of tax increases, provided that such increases were essential to assure a strong, credible, downward trajectory in projected deficits. At the same time we made it clear that we were not advocating tax increases in isolation. It is imperative that the central focus of deficit reduction be directed toward restraining the growth of government spending, particularly in those areas where expenditures have been on "automatic pilot" with little or no control by the Congress or the Administration.

Congress recognized the need in 1981 for a greater emphasis in our tax laws towards capital formation and productivity growth. That need still exists. TEFRA, unfortunately, eroded almost half of the capital cost recovery incentives enacted in 1981 before they even had a chance to take effect. Business, which received a small share of the ERTA benefits, wound up with a large share of the various tax increases, including social security, enacted since 1981.

Looking ahead, it is apparent that there will be serious legislative efforts to restructure the federal tax system. Congress and the Administration both appear to perceive the need for new revenue sources in the 1986–1988 time frame, particularly if we are to move toward a balanced budget. The Roundtable hopes that major changes to the tax laws would increase the flow of savings and investment, strengthen U.S. exports and provide a less complicated tax code.

STATEMENT

Mr. Chairman, distinguished members of the Committee. My name is Theodore F. Brophy. I am Chairman and Chief Executive Officer of GTE Corporation. I serve as Co-Chairman of The Business Roundtable and Chairman of its Taxation Task Force. The Roundtable is an organization comprised of approximately two hundred chief executive officers representing corporations that invest billions of dollars of capital and provide millions of jobs in the American economy. I sincerely appreciate the opportunity to appear before you today on behalf of the Business Roundtable and to present its views concerning the nature and timing of the legislative response to the revenue reconciliation instruction included in the Conference Report on the First Concurrent Resolution on the Budget for Fiscal Year 1984.

I believe that it is important to note that these hearings on proposals for revenue increase have been called as a result of budget activity by the Congress. Projected revenue streams for the federal budget are impacted significantly by anticipated economic conditions and prospects for new tax legislation. During the past several years tax policy decisions have become closely linked to overall budget policy and the surrounding economic environment.

The Roundtable has for some time been deeply concerned about the high level, structural nature and trendline of projected federal budget deficits. Our organization has long been convinced that unless these deficits were placed on a decisive downward slope, they would siphon off large amounts of private capital from the financial markets, cause interest rates to rise and stifle economic recovery.

An uneven recovery

It is generally agreed that a recovery is firmly underway. The consensus forecast is that real GNP will grow by 3.0 percent this year and 4.8 percent next year. However, the recovery has been very uneven so far. As shown in Exhibit I, residential construction and consumer spending for durable goods are leading the recovery. But investment in new plant and equipment is still at recession lows and exports of goods and services are still declining.

What the Roundtable is seeking is a well balanced recovery, one that will foster capital investment as well as increased consumption. Growth of investment is needed to support high productivity, creation of jobs, and growth. It is also vitally essential if we are to restore U.S. competitiveness in the world marketplace. Consumption spending alone can not provide the framework for long-range growth.

The economic recovery will go a long way toward closing the cyclical portion of the deficit gap. It will expand the tax base and provide additional tax revenues. Our first order of business, therefore, should be to assure that the recovery stays on course—a far more efficient and effective way to close the deficit gap than tax increases. But continuation of the recovery is by no means guaranteed in today's uncertain economic environment. A recovery is underway, but its sustainability should not be taken for granted.

Fiscal year 1984 tax increase will not solve deficit problem

Assuming that the recovery does continue for several years, however, we will still be left with a very substantial gap between estimated revenues and expenditures that must be addressed by the Congress—this is the so-called structural portion of the deficit. The Roundtable believes that the major emphasis for closing this remaining gap must come from reductions in the growth of government spending. Toward this end, we issued a policy statement during the first quarter of 1983 citing five areas where essential savings could be achieved on the expenditure side of the budget; namely: Defense, social security, a freeze for twelve months of most nondefense discretionary programs, a permanent limit on cost-of-living adjustments for non-means-tested entitlements, and additional long-range savings in medicare.

Unfortunately, only the first two areas have been addressed to any significant degree. We were deeply disappointed that the first concurrent resolution passed by the Congress made little headway in tightening spending in the other three areas.

Although the budget resolution provides for higher non-defense spending than the Administration proposed earlier, its deficit projections are in line with those of the Administration. In both cases our organization views the projected deficits as being unacceptably high. The Roundtable believes that the major thrust of deficit reduction activity must be directed at the spending side of the budget. If sufficient success is achieved in that area, we would support revenue-raising to reduce the level of deficits more sharply and keep them trending downward on a year-to-year basis. Lower deficits would, of course, provide us with an automatic benefit in the form of lower interest charges in future years.

However, until adequate restraint is placed on the spending side, we believe that revenue-raising should not be considered. Accordingly, the Roundtable does not support a $12 billion tax increase for fiscal year 1984, as called for in the budget resolution.

Dimensions of the problem

Now that a recovery is underway, the single most important issue facing the economy is the size of the projected budget deficit. Exhibit II shows the trend of federal revenues and expenditures over most of the postwar period as a percentage of GNP. The shaded area in the chart indicates the deficit.

Although there have been cyclical ups and downs in both revenues and expenditures over this period, the chart clearing shows that the trend of expenditures (as a percent of GNP) has been upward over most of the postwar period. The long-term trend of tax revenues also appears to tilt slightly upward, and the large tax cuts, enacted in 1981, that have been so widely publicized, have been offset in part by large tax increases, including the one for social security, enacted during the past two years.

In order to take a closer look at these trends during major recovery periods, Exhibit III presents a comparison of three recovery intervals excerpted from Exhibit II. This chart has the advantage of eliminating some of the distortions caused by intervening cycles. It also presents a clearer picture of the underlying trends.

Exhibit III makes several important points:

Taxes as a percent of GNP in the present recovery appear to be roughly in line with the two earlier recoveries.

Federal spending as a percent of GNP, on the other hand, has ratcheted upward substantially compared to the experience of earlier recoveries.

The deficit as a percent of GNP has also become substantially larger over the succeeding decades. Moreover, in the present situation, the deficit is projected to remain unacceptably large even after three years of recovery. This suggests that the structural deficit is expanding rather than contracting.

As the recovery progresses, these large structural deficits will distort the economy in two ways: first, they will cause interest rates to rise; and second, they will tend to "crowd out" private capital investment in new plant and equipment.

Large deficits during a recovery will contribute to higher interest rates either because of an increased demand for funds or because of renewed inflationary expectations. High interest rates tend to distort the recovery by depressing capital investment. They also contribute to the high value of the U.S. dollar in foreign exchange markets which tends to depress exports and favors imports. Current forecasts anticipate a $60 billion U.S. merchandise trade deficit this year. A significant improvement in the export picture could have a dramatic impact on the unemployment situation. By one estimate, each $1 billion increase in real net exports (1972 dollars) creates from 60,000 to 70,000 jobs once the multiplier effects are realized.

Deficits generally tend to crowd out spending for investment more than spending for consumption. The Federal government is expected to take about 60 percent of all funds raised in the credit markets during fiscal year 1983, up from 33 percent during fiscal years 1980–81 and 49 percent during fiscal year 1982. To place this problem in perspective, a look at the period 1973–1979 reveals that federal participation in the credit markets averaged about 25 percent.

While it is possible that personal savings could provide adequate funds to satisfy both private and public financing needs, this seems unlikely in view of the enormous size of the projected deficit. Total net savings of the private sector has averaged only about 7 percent of GNP over the past twenty-five years and is currently running at 6 percent of GNP. Obviously, with the deficit accounting for about 5 percent of GNP, most of the available savings will be absorbed by the deficit and there will be very little left for capital formation beyond replacement needs which are satisfied through depreciation.

Large deficits also increase the risk of an early end to the recovery. The deficits make it more difficult for the Federal Reserve to control money supply growth. They also place a greater burden on monetary policy as the only instrument for controlling inflation. A premature or excessive tightening of monetary policy could abort the economic recovery or, alternatively, a failure to tighten adequately could lead to another round of high inflation.

Revenue increases

The Roundtable has tried to maintain an open mind during the past two years toward the subject of tax increases, provided that such increases were essential to assure a strong, credible, downward trajectory in projected deficits. At the same time we made it clear that we were not advocating tax increases in isolation and did not believe that the revenue side should bear the heaviest part of the burden in the quest to close the deficit gap.

It is imperative that the central focus of deficit reduction be directed toward restraining the growth of government spending, particularly in those areas where expenditures have been on "automatic pilot" with little or no control by the Congress or the Administration. So far, Congress has not shown that it is planning to enact adequate restraints on spending for fiscal year 1984. Because the spending side has not been properly addressed, the Roundtable believes that it is premature to discuss initiatives to increase revenue collection.

Since continuing large deficits may lead to "crowding out", it is important to note that spending reduction is a far more effective and efficient way of alleviating "crowding out" than a tax increase. Furthermore, an income tax increase, as opposed to a consumption tax increase, may be self-defeating in this context because it would tend to reduce savings. A dollar of tax extracted from the savings pool has essentially the same "crowding out" effect on the private sector as a dollar of government borrowing which also must come out of that same savings pool.

Congress recognized the need in 1981 for a greater emphasis in our tax laws towards capital formation and productivity growth. Unless our nation modernizes its industrial plant and continues to dedicate substantial funds to reseach activities, our economy will not maintain its competitiveness on a worldwide basis. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), unfortunately, eroded almost half of the capital cost recovery incentives enacted in 1981 before they even had a chance to take effect on the economy. Business received a small share, between 20-to-25 percent, of the total benefits enacted in the Economic Recovery Tax Act of 1981 (ERTA), but wound up with a large share, well over 50 percent, of the total TEFRA tax increase in 1982.

Business will also participate heavily in meeting the increased tax burden generated by the Surface Highway Assistance Act and the Social Security Reform Act. Tax increase legislation has dominated the Congressional agenda for the past two years. It is our firm hope that the capital formation incentives remaining from ERTA will be left in place since we believe they are critical to sustain economic recovery. The First Concurrent Budget Resolution for fiscal year 1984 calls for revenue increases of $12 billion in fiscal year 1984, $15 billion in fiscal year 1985 and $46 billion in 1986. Earlier in the year the Administration had proposed raising taxes by about $40 billion in fiscal year 1986, providing that certain conditions were met by 1985. So, while there is a considerable distance between Congress and the Administration concerning short-range tax increases, as one looks further outward, there appears to be less distance between the thinking of these two bodies, at least from a quantitative standpoint.

Assuming that the growth in spending can be sufficiently restrained and the deficit is narrowed through economic recovery, it still appears that new long-term revenue sources will be needed for the fiscal years 1986–1988 time frame if our goal is to eliminate deficit financing and achieve a balanced budget. This Committee will, of course, play a critical role in determining the scope and eventual outcome of the forthcoming debate on the most appropriate long-range national tax policy.

Major structural changes to our tax laws should not be enacted without careful study, public education and Congressional debate. The complexity of the tax system and its bias against savings and investment, as opposed to consumption, dictate thorough review by the Congress before any major revisions are initiated. Our organization would certainly hope that any major structural revisions to the tax code in the future would:

Increase the flow of funds for savings and investment.

Strengthen U.S. export trade.

Provide a less complicated set of tax rules.

Plan for a smooth transition from current standards.

The outcome of the debate on long-range tax policy will have a critical impact on the overall future health of the economy. Since the future pattern of jobs, productivity and real incomes are at stake, it is essential that Congress exercise the utmost vision and care in any major restructuring of the tax system.

CONCLUSION

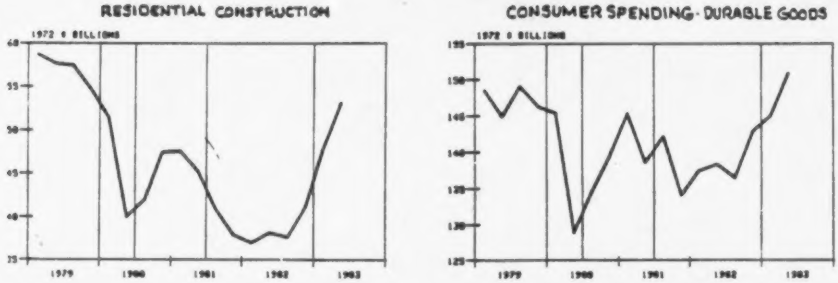
Although the economic recovery is gaining momentum, at the present time it is uneven across various sectors of the economy and its sustainability is threatened by the large size of projected budget deficits. The magnitude of these projected deficits place upward pressure on interest rates. High interest rates discourage essential capital investment, weaken exports and ultimately, reduce the chances for solid, well-balanced, long-term economic growth.

The business community still remains deeply concerned that, even with a strong recovery, the structural portion of the deficit will stay unacceptably high. These deficits must be placed on a decisive downward slope.

The most effective way to reduce deficits and assist economic recovery is by additional reductions in spending beyond that currently projected in the first concurrent budget resolution. This Committee has been instructed to propose revenue increases for fiscal year 1984 of $12 billion. The Roundtable feels strongly that until the expenditure side of the budget is adequately addressed, it will not support revenue-raising action by this Committee or the Congress.

EXHIBIT I

RECOVERY UNEVEN ACROSS MAJOR SECTORS
(In Constant Dollars)



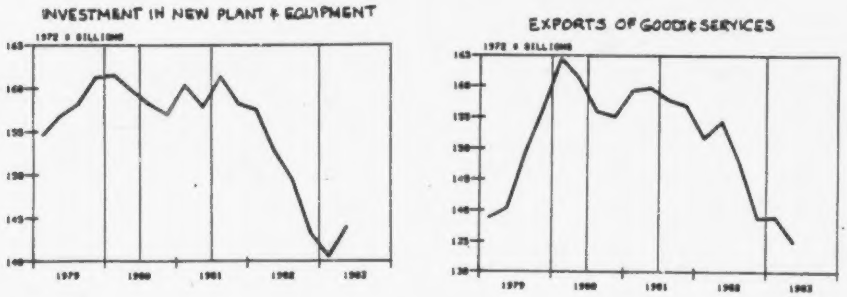
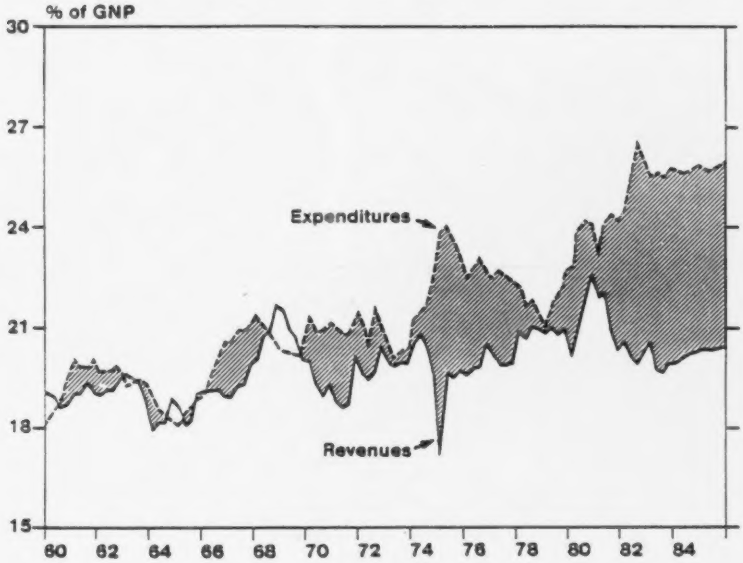


EXHIBIT II

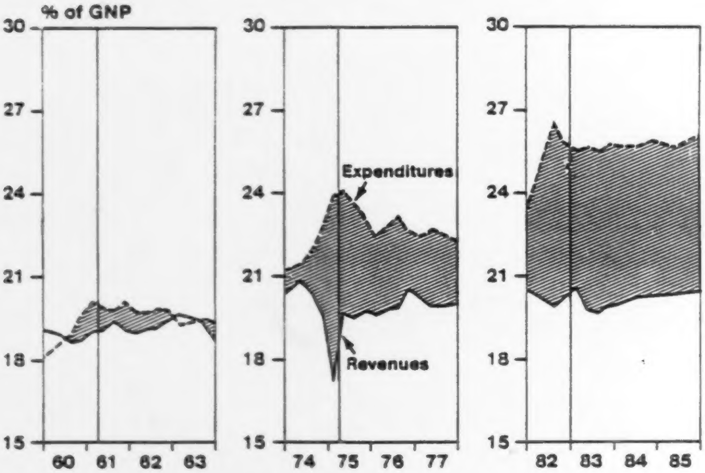
ANALYSIS OF GOVERNMENT SPENDING AND TAX REVENUES AS A PERCENT OF GNP



Source: Data Resources U.S. Review, July 1983

EXHIBIT III

ANALYSIS OF GOVERNMENT SPENDING AND TAX REVENUES AS A PERCENT OF GNP



(Vertical Lines Represent Recession Troughs)

Source: Data Resources U.S. Review, July 1983

Mr. JENKINS. Thank you very much, Mr. Brophy.

You indicated that the Congress has not properly addressed the spending side which is where you think the emphasis should be. I tend to agree with that.

But as I understand your testimony, you are willing to live with a higher deficit by not addressing the revenue side at all.

Mr. BROPHY. We are very concerned that addressing the revenue side first is not going to solve the problem and might in fact even incur or encourage additional spending. Therefore, we believe it is imperative that the spending side be addressed and if you look at the exhibit 2 to my written testimony, you will see that the revenue side as a percentage of GNP has remained relatively flat during the period 1960 to 1984, on an estimated basis; and the real villain is the expenditure side.

We see expenditures going up to over 24 percent of GNP and remaining at that level and we don't believe that the economy can sustain that kind of percentage GNP taken out of the economy by the Federal Government spending.

Mr. JENKINS. As I indicated before, I tend to agree with you. But assuming that we don't address the spending side, would you then prefer the result of the larger deficit to taking the risk on raising taxes?

Mr. BROPHY. I think the elimination of the deficit by increased taxes is going to be such an unhappy result for the economy in the long run that it doesn't provide a solution standing alone.

Mr. JENKINS. You indicated that we had addressed only two of the five areas that your organization had recommended for spending reductions and that was defense and social security.

Mr. BROPHY. Yes.

Mr. JENKINS. You make no recommendations for further reductions in either of those two areas?

Mr. BROPHY. I think obviously we would have preferred to see further reductions accomplished on the social security side but we are very conscious of the comment that Congressman Conable just made to Mr. Rohatyn, and we do not have a proposal at the moment on that side.

I believe it would be desirable, in fact imperative, that we address the problem of cost-of-living increases in the nonmeans-tested entitlements and if Congress believes that that kind of subject can include a further consideration or reconsideration of social security we would not be opposed to it.

Mr. JENKINS. You recommended no further reductions in the defense area?

Mr. BROPHY. We recognize there have been cutbacks from the President's proposal on defense. We think defense spending should continue to be examined.

Mr. JENKINS. Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman.

Welcome back to the committee, Mr. Brophy. You must feel familiar since you are here so many times. We thank you for your interest and public service in appearing.

Mr. BROPHY. Thank you.

Mr. CONABLE. I don't want to blindside you on anything but the President announced this morning that the growth of GNP in the second quarter was not the estimated 7.2 percent that we saw earlier, but in fact was 8.7 percent. That indicates a much sharper recovery than had been anticipated in the second quarter.

What does this mean? Of course the savings rate continues to be about 4 percent. That reflects, I suppose to some extent, increased sales of autos which are considered consumption rather than investment. But are we having a much sharper recovery than anticipated? It is certainly uneven. Your charts prove that.

What are the dangers involved here and is this likely to be interpreted in such a way that we will have a further call for contraction of monetary growth to dampen such a sharp upswing?

Mr. BROPHY. I think we should be very cautious in reading too much into the figures released this morning. I think that they do reflect the earlier substantial drawdowns in inventory levels and now we are beginning to see some buildup, but I don't think at the moment with the underutilization of capacity that we need to be concerned about a heating up of the economy.

There are surely large segments of the economy that are still in deep financial trouble and I think will continue to have problems for some period of time.

Mr. CONABLE. Plant capacity is up to about 74 percent. There is obviously a high degree of obsolescence in our American plant structure. How high can it go before we start pressing?

Mr. BROPHY. Obviously I think we need to make more capital investment. In the steel industry of course there has been substantial close-down of old capacity. On the savings rates that you mentioned, I thought I had seen in this morning's paper that the savings rate was at 3.3 percent, the lowest level——

Mr. CONABLE. It is below 4 percent but I am not sure exactly where.

Mr. BROPHY. It is the lowest level we have seen in some substantial period of time. Clearly we do need to reinvest in our infrastructure industries and need to modernize our industries if we are going to be competitive in the world marketplace. Obviously high levels of interest are going to have an impact on the ability of industry to do that.

Mr. CONABLE. Thank you, Mr. Chairman.

Mr. JENKINS. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Mr. Brophy, I think I understand what you responded to the chairman about the attitude of the Roundtable toward any tax increase absent spending. We have a first concurrent budget resolution which has been adopted by the House and the Senate as you know, and the changes on the spending side may not be entirely as good or go as far as you might like, but I certainly have the impression that the Congress did make some substantial modifications of its own desires on the spending side.

There was a good deal of restraint built in as compared with what many of the authorizing committees would really like to have.

Also, then, as part of that resolution, reconciliation instructions call for more revenue.

Do you not recognize any achievement at all on the part of the first budget resolution in the area of spending restraint?

Mr. **Brophy**. I think there obviously were some areas where efforts were made and I don't underestimate the difficulty of the problem, Congressman Pease. I do have grave concerns as I see the tremendous growth in entitlements and recognizing they are approaching 47 percent of the budget, I think relatively little, very little has been done there, and I think if you look at chart 2 in my prepared testimony and see what has happened in the growth in expenditures from the 18-percent level back in 1960, to over 24 percent at this particular point in time, and with a continued upward trend, one cannot help but feel a great deal more has to be done if the economy is ever going to be made healthy again.

Mr. **Pease**. But just to clarify for sure what you said in response to the chairman. In response to our constituents, Congress will probably not cut back on social security—anybody who talks about limiting the COLA's or social security is just dreaming—and yet that is a very large entitlement.

We are responding to our constituents and if we respond to them and do not cut spending, you, the Business Roundtable, would be in favor of no tax increases at all; is that correct?

Mr. **Brophy**. We would not recommend any tax increases at this time if there is not further response on the spending, that is correct.

Mr. **Pease**. And you feel that the economy can handle the deficit situation which will result?

Mr. **Brophy**. We are very concerned about it. We think in the long run the economy cannot handle that level of deficit. We think in the long run that it is going to take a combination of spending cuts and revenue raising if we are really going to get the deficits on a downward track.

I think our concern is that constituencies are always going to favor expenditures that they find to be attractive for them, particularly if they don't have to pay for them through the tax process. This is what we are doing right now.

Mr. **Pease**. Given the difficult situation we are in with respect to deficits, would the Business Roundtable counsel the Congress not to go any further down the road of eroding the current tax base? For example, there is a proposal floating around for allowing basic industries to borrow from the Treasury the amount of their unused tax credits, and that would be a substantial loss of revenue.

Would you support that given the current budget strictures or not?

Mr. **Brophy**. We have not addressed that specific issue and since I am really here representing a constituency I cannot give you a response on that at all.

Mr. **Pease**. Thank you very much.

Mr. **Jenkins**. Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

Mr. Brophy, I appreciate very much your testimony. I noted with great interest your emphasis on the expenditure side. I share many of your views that Federal spending as a percentage of GNP is too high. But I notice that your comparisons, I believe, compared revenue in this recovery with revenue in previous recoveries.

I was wondering if you would agree with another comparison. I think in 1980 spending was about 23 percent of GNP and revenue was about 22 percent of GNP and since 1980 through 1984 the GNP has been relatively flat. What I am trying to do is compare spending from 1980 to 1984. I think that spending has increased from 23 percent to roughly 24 percent over that 4-year period, while revenues went from 22 percent to 19 percent roughly.

Would you agree with those rough figures?

Mr. BROPHY. I don't have those figures in front of me, Congressman Flippo, but I would accept your word if those are the accurate figures.

Mr. FLIPPO. The point I am making is that spending has increased roughly by 1 percent of GNP over the 4 years, while revenues decreased in the neighborhood of 2 percent of GNP, so that in 1984 they are projected to be about 19 percent.

The greatest increase in that 1-percent increase in spending over that 4 years has of course been in defense and even so I still agree that spending is too high relative to GNP.

Mr. BROPHY. If I can make one comment there, of course during a recession you always see a drop in revenue as a percent of GNP because of the impact of the recession.

Mr. FLIPPO. Indeed you do and you also see an increase in expenditures for unemployment and other programs related to unemployment either over that same period of time, don't you?

Mr. BROPHY. You do. I think what I tried to do in exhibit 3 is look at the recovery periods, the great concern this time is that we don't see or forecast a reduction in the deficits, and what we see instead is a continued high level of spending, we see revenues as a percent of GNP at levels at least as high as they have been in the last recoveries and the structural deficit has not existed before.

Mr. FLIPPO. Is it fair to say the structural deficits in the area of $80 billion to $100 billion and the cyclical deficit is in that neighborhood as well?

Mr. BROPHY. I would guess the structural deficit is at least in that area, yes.

Mr. FLIPPO. Since 1960 the deficit that we have experienced has been in the area of 1 to 2 percent of GNP; the deficit we are now facing is 5 to 6 percent of GNP but the structural deficit is still 1 to 2 percent?

Mr. BROPHY. I think the structural deficit probably exceeds 1 or 2 percent at this moment. If the figures on my chart appear accurate we are looking at between 3 and 4 percent as the structural deficit. I think it should be a maximum of 1 percent.

Mr. FLIPPO. I agree with that. How much do you think—we are going to grow if the economy continues to expand. We will probably be able to correct $100 billion of the deficit through growth over a period of time but now there is no plan on the table to deal with the structural deficit.

Mr. BROPHY. That is correct.

Mr. FLIPPO. From what you recommend I guess you are saying that if you cut expenditures then you can look for revenue increases as a means of attacking the structural deficit.

Mr. BROPHY. I think it is going to take a combination of the two, and you have to address the spending side first. I am sensitive to saying anything on the revenue side because there is a tendency to quote the Business Roundtable as being in favor of tax increases and that is not the case.

Our strong emphasis we believe has to be on the spending side. We cannot have, we believe, Government spending, Federal Government spending at 24 percent of GNP on a continuous basis and maintain a strong economy.

Mr. FLIPPO. I understand your emphasis but I want to know what the position of the Roundtable would be if you could get control of expenditures along the lines you have mentioned.

So let me pose this question to you. What would be the position of your organization to a proposal to eliminate indexing of both revenues and non-means-tested entitlement expenditures?

Mr. BROPHY. We would like to look at that closely.

We have not taken a position on it but it would be something we would like to examine. I would not reject it out of hand.

Mr. FLIPPO. I thank the chairman.

Mr. JENKINS. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Brophy.

The corporations now pay about 8 percent of our collectible income tax. This is down over the last few years from 16 percent. Where do you feel the balance should be between the private individuals and corporations and the responsibility that corporations should have under our Tax Code?

Mr. BROPHY. I think we have to recognize where the source of all taxes is and the source of all taxes is individuals. I don't know that a balance is a particularly important focus.

I think it is the totality of the taxes. Obviously the taxes paid by corporations end up being reflected in prices of goods and services so they are in the last analysis paid by the consumer.

Mr. GUARINI. Mr. Rohatyn said that a minimum corporation tax of 25 to 30 percent should be expected. Do you agree with that?

Mr. BROPHY. I would have to disagree with it and I think it depends on how it is measured. Obviously if you look at the steel industry as a whole, it has lost over $1 billion last year, the airline industry lost some $600 million last year. There is nothing to apply the tax to. So I think when we use averages and talk about the average tax paid by industry I think it is misleading.

Mr. GUARINI. Do you agree with the fact that banks are taxed at an effective tax rate of 2 percent, insurance companies at 1 percent?

Mr. BROPHY. I think that is a matter of how you compute taxes and if you are asking me whether I think that the profits of banks are too high, I don't believe they are.

Mr. GUARINI. Do you think insurance companies have a greater social responsibility than 1 percent effective income tax rate?

Mr. BROPHY. I think it is a balance between the cost of insurance and the level of taxes paid.

Mr. GUARINI. Do you think that capital gains which IRS says are collectible at 56 percent rate, that there should be efforts made to collect the capital gains that are due our country where 44 percent of the people are not paying capital gains taxes?

Mr. BROPHY. I am not sure how you derive your figure. If there are capital gains taxes that are due by U.S. citizens, is this your suggestion, that they are not paying?

Mr. GUARINI. There is a great uncollectibility of our capital gains taxes in this country, sir, and it is estimated that 44 percent is not recovered by our tax collections.

Mr. BROPHY. I think the Business Roundtable has consistently favored improved collection processes.

Mr. GUARINI. Do you feel that the $12 billion that is suggested to be raised under our budget would make a substantial difference to our recovery in a $3 trillion economy?

Mr. BROPHY. I think that the raising of additional taxes at this particular time could have an impact on the recovery, yes.

Mr. GUARINI. So $12 billion would have a significant impact on a $3 trillion economy in your opinion?

Mr. BROPHY. I think it is possible it could. I think particularly the message that it would give in raising taxes at a time that we are not slowing down the growth in spending would have a negative impact.

Mr. GUARINI. What distresses me is many people come and talk about dollars but they don't talk about jobs or putting America back to work as if we had that. Then there would be more payment in the social security, of course, and more payment to unemployment and social services, there would be payment into our health funds, we would have more tax collectibles.

That would really help to eliminate some of the $200 billion deficit that we have.

Mr. BROPHY. I agree with that.

Mr. GUARINI. Do you have any suggestions about putting America back to work, sir?

Mr. BROPHY. This is a great concern to the Roundtable. I think foreign trade is a very important part of this. I think each billion dollars in foreign trade represents 60,000 or 70,000 jobs in the United States, for each billion dollars of exports. That is one of the reasons we have been very concerned about the impact and strength of the dollar. It is one reason we have been pressing the Government to take a greater interest in the area of foreign trade and relationships with Japan in that particular area.

Mr. GUARINI. That makes a very valid point, sir. Our hard dollar is what allows people to sell to our country at great discount rates, the yen at maybe 20 or 25 percent.

Mr. BROPHY. That is correct.

Mr. GUARINI. What is the Roundtable's solution to the hard dollar? I know it is very difficult as a problem but this is one of the problems that we have in foreign trade where we have a $70 billion deficit and it puts us at a total disadvantage. Does the Roundtable have any suggestions as to how we could temper our hard dollar?

Mr. BROPHY. Yes, the chairman of our Committee on International Trade, Lee Morgan of Caterpillar, has put out a paper on this and I will make sure you receive a copy of that.

[The information follows:]

STATEMENT OF LEE L. MORGAN, CATERPILLAR TRACTOR CO., BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE, ON BEHALF OF THE BUSINESS ROUNDTABLE, APRIL 7, 1983

Thank you Mr. Chairman. It's a pleasure to be here this morning—on behalf of the Business Roundtable—to discuss a matter that I have often characterized as the single most important bilateral economic problem confronting the United States and Japan.

Of course, I'm referring to the sustained undervaluation of the Japanese yen and the implications of that undervaluation for the relative competitiveness of U.S. and Japanese goods in the world marketplace.

Mr. Chairman, I have a prepared statement that I believe addresses most of the questions you posed in your letter of invitation. In addition, I'd like to briefly comment on the remarks just made by Mr. Alan Mendolowitz, of the General Accounting Office.

As we look at the issue before us, I don't believe it's very constructive for us to debate whether the Japanese yen has stayed undervalued, relative to the dollar. I don't hear any credible economists saying there isn't an exchange rate problem. Unfortunately, that's where the consensus ends. There is not total agreement on the causes of the yen-dollar misalignment, or what to do about it.

Because of this vacuum, I, along with my colleagues in the Business Roundtable, undertook to develop a list of suggestions for action by the U.S. and Japan to address the yen-dollar imbalance. We've presented these proposals to our Administration, and offer them today to help further this Committee's debate on the topic.

In asking for action, I would remind policymakers in Washington and Tokyo that many Japanese businessmen are expressing as much concern about this problem as we are. I'd like to read an excerpt from a speech recently made by Isamu Yamashita, director and chairman of Mitsui Engineering and Shipbuilding Co. He said:

"Looking back at the past year, I think we can say that without question one of our most serious problems in Japan has been the misalignment of the dollar and the yen . . . the undervalued yen added fuel to the flames of international resentment against Japan, worsening our trade relations with the United States and increasing protectionist sentiments. I am deeply, deeply concerned about this problem.

"The reasons for this problem are complex, but the most obvious ones include high interest rates in the U.S. and the lack of investment opportunities in Japan . . . of course, all major currencies were affected by the same phenomenon, but the misalignment is more extreme in the case of the yen because the yen is not fully internationalized and more subject to speculative fluctuations."

Mr. Yamashita continues:

"This is one reason why we support continued steps to internationalize the yen. It is also important for the United States to take macro-economic policies that take into account the competitiveness of the U.S. economy in world markets. In a longer run sense, both our governments need to review the operation of the international monetary and financial systems and to try to explore imaginatively ways and means of designing a system beneficial to trade. The main point is that neither country can correct the present misalignment alone; both must take steps."

Mr. Yamashita stresses precisely the points that U.S. businessmen have been making. Now we'd like to see our government take some initiatives to correct the problem.

We should acknowledge here today that from its absolute weakest point last November of 278 to the dollar, the yen has strengthened to its present value of about 235 to the dollar. However, viewed over the perspective of the last four years, in real terms adjusted for differences in inflation, the yen is still 35 percent weaker than it was in 1978.

During the last four quarters for which full economic information is available, Japan's exports of goods and services in constant yen grew at a 4.9 percent rate, while those of the United States, France, United Kingdom, and Germany declined at rates of from 6 to 13 percent.

These facts argue rather conclusively, in my opinion, that the problem cannot be brushed aside as the strength of the U.S. dollar; rather, the facts point to the weakness of the Japanese yen. Japanese export performance continues to be relatively strong at the expense of other industrial nations.

Clearly, this situation demands action. To say there is consensus in the business community on evey detail of a proposed program would be an exaggeration. But some general themes and specific recommendations have clearly emerged and I would like to summarize them for you.

Many analysts agree that the appropriate yen/dollar exchange rate should today be no weaker than 200 yen to the dollar. This figure represents a basic structural equilibrium rate around which short-term cyclical variations could occur. Variations have occurred in the yen-dollar rate in the past year, but they've been around a signficantly higher base than 200/1.

The interest rate spread between the U.S. and Japan is a major factor affecting the relative valuation of the currencies. There is general agreement that while Japanese savings propensities are an important contributor to this differential, conscious insulation of the yen from worldwide interest rate trends exaggerates the spread.

Thus, we recommend policies in both countries to reduce that interest rate differential.

In the United States, the reduction of real interest rates must continue to receive high priority attention. This will require firm control over the growth of the U.S. budget and the deficit.

To complement our domestic efforts, the United States should insist that Japan allow its interest rates to be set by market forces. An induced, short-term raising of Japanese interest rates is not sufficient. The basic factors that underlie the interest rate distortion need to be addressed.

Highest priority should be given to liberalization of Japanese financial and capital markets and especially the encouragement of capital inflows. The much-touted reduction of Japanese capital flow barriers has been one-sided. Capital now flows out of Japan much more freely than it did in the past. But there has been no commensurate increase in capital inflows. This one-sided adjustment in capital flows is a major contributor to the yen-dollar exchange rate imbalance.

Restraints on the flow of yen need to be removed. Ultimately, there should be complete internationalization of yen financial markets. In my statement I've listed a number of possible Japanese actions directed toward this goal.

(1) Elimination of the yen interest rate ceilings on loans and deposits in Japan.

(2) Removal of restraints on the issuance of yen bonds and on short-term yen-denominated bank borrowing by foreign investors.

(3) Increase in the limits on certificates of deposit denominated in yen.

(4) Establishment of a treasury bill market in yen, open to foreign investors.

(5) Allowing importers to finance in yen, rather than having to borrow dollars to pay for imports.

(6) Allowing other governments to hold more of their reserves in yen.

(7) Undertaking aggressive foreign borrowing, with the proceeds converted to yen.

(8) Allowing purchase of yen in the forward exchange markets without restrictions.

Concurrently, Japan needs to take steps to liberalize foreign direct investment. The government's screening and approval process remains a major obstacle to foreign direct investment. Restrictions on stock purchases make it very difficult for a foreign entity to acquire a Japanese company.

Most of the actions I've discussed are aimed at achieving an appropriate long-term equilibrium in the yen-dollar relationship. But there needs to be short-term action as well, because in the view of many of us, the problem is critical to our short-term economic vitality. Thus, we propose the following:

(1) Declare it a problem. The imbalance in the yen-dollar relationship is, in the view of Japanese and American businessmen, causing economic and political problems for both sides. A simple joint declaration, by the U.S. and Japan, that the governments intend to undertake a joint program to bring the exchange rate to an appropriate level will help strengthen the yen relative to the dollar.

(2) Undertake joint intervention in support of the yen. The United States could convert more reserves into yen; Japan could reduce permanently its large dollar reserves.

(3) For "shock effect," it may be necessary to impose a surcharge on Japanese goods. We believe this can be accomplished consistent with both countries' obligations under the GATT.

(4) We believe the U.S. should immediately request that the IMF look at Japanese exchange rate relationships. The IMF Articles of Agreement call for a review of a country's policies that affect exchange rates where the exchange rates allow an unfair competitive advantage over other members. We believe the present situation demands such a review.

Let me repeat that we view these four measures as temporary and needed to provide immediate correction of a major problem. Hopefully, implementation of the longer range measures discussed earlier would obviate the need for long-term intervention and surcharge programs.

Finally, I'd like to address the question of whether the present international system that determines exchange rates really works properly. Many people believe it does not; that is, there is broad concern that capital movements are overwhelming the traditional role of trade flows in determining exchange rates.

Technically, the present system should dictate exchange rates that reflect the trade competitiveness of the trading partners. But that technical purity is destroyed by the kinds of trade and capital flow barriers that the Japanese maintain. So, it seems appropriate that the United States seek to determine what kinds of modest or major adjustments need to be undertaken, to assure that the exchange rate system works equitably.

Mr. Chairman, in summary, let me repeat three general themes that run throughout this presentation:

(1) The present system of exchange rates is not properly accounting for trade competitiveness. Its failures are influencing the protectionist sentiments that are growing in the world. This may require some strengthening of our international institutions—like the GATT and IMF—to deal with exchange rates more effectively. But unless all nations play the trade and investment game fairly and equitably, there is no exchange rate system that will provide satisfactory results.

(2) The U.S. has a part to play in resolving this problem. U.S. domestic policy decisions must take greater cognizance of the implications for our position in the international marketplace.

(3) A heavy burden lies on the Japanese' shoulders. They must, either by their own initiative or by force of outside pressure, take major steps to open their capital markets and internationalize their financial system. The U.S. business community is fully prepared to undertake initiatives as needed to assert such pressure.

Mr. Chairman, I'll thank you and the Committee in advance for your attention to the set of recommendations I've just laid out. We believe the U.S. and Japanese governments should be able to build on the framework we've set out here. We urge both governments to do so.

I'm prepared to address any questions you may have.

Mr. BROPHY. We have made a number of suggestions on things that could be done to improve the relationship between the dollar and the yen.

Mr. GUARINI. The committee would very much like to see that.

Mr. BROPHY. We will see you get it.

Mr. GUARINI. Thank you.

Mr. JENKINS. Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Brophy.

I don't have any questions. I want to thank you for coming. I want to say, too, as former head of GTE I want to thank you as a tampan for all the things you contributed to our community.

Mr. BROPHY. Thank you very much.

Mr. GIBBONS. And what you are doing for the Nation in your present role.

Mr. BROPHY. I appreciate that.

Mr. JENKINS. Thank you, Mr. Brophy.

Mr. BROPHY. Thank you.

Mr. JENKINS. Our next witness is a panel, if you would come forward. Mr. Philip Smith, chairman of the tax committee, Grocery Manufacturers of America, Inc.; Mr. Denis Zegar, vice president of government services for National-American Wholesale Grocers' Association; Mr. John Martin, Jr., tax counsel for Food Marketing Institute; Ms. Jeanne Campbell, vice president, the New England Council, Inc.; Mr. Jack Blum, counsel for Independent Gasoline Marketers Council; and William F. Kenney III, president of Meenan Oil Co., Inc., representing Empire State Petroleum Association.

I want to welcome the panel, in particular Mr. John Martin, who I don't believe has been before the committee since he left the committee after serving so many years in a very distinguished manner. John, we welcome you back

Let me say to the panel that your written testimony will be included in the record as prepared and submitted. You may summarize or present your testimony as you desire.

We will begin with Mr. Martin.

STATEMENT OF JOHN M. MARTIN, JR., TAX COUNSEL, FOOD MARKETING INSTITUTE

Mr. MARTIN. Thank you, Mr. Chairman.

I certainly appreciate those kind remarks. It is a pleasure to be back before this committee that I served under so many years. It is different being on the other side of the rostrum.

I do ask that my statement be placed in the record and I would simply like to summarize.

I represent the Food Marketing Institute. On the first page of my statement I describe the nature of our organization. We have over 1,100 member companies that operate over 17,000 retail food stores and wholesale stores in the United States with annual sales of $125 billion—over half the grocery sales in the country. More than three-fourths of the FMI membership is comprised of independent supermarket operators or small regional firms. So we have a broad-based membership.

Mr. Chairman, in the statement I make the following points and I will try to be very brief.

On pages 2 and 3 we state that FMI is strongly and unconditionally opposed to the President's proposed contingency tax. We believe that the proposed surtax is bad economic policy, bad tax policy, and should be summarily rejected.

It is an inherently unfair and inequitable method of raising additional revenue. I go into the reasons in the early part of my statement.

Second, Mr. Chairman, on pages 3 and 4 we point out that the grocery industry is presently paying among the highest effective income tax rates of any industry in the United States. In all of the surveys which we have examined, our industry's effective tax rate is shown to be very high relative to other industries. Our own latest annual survey which we believe to be the most representative and broad based of the surveys examined, showed an effective income tax rate for the food marketing industry of 37 percent in 1980 and 1981 and 35 percent for 1981 and 1982.

Many companies are in the range between 35 and 45 percent.

Third, on pages 4 and 5 we state that the effective income tax rates do not take payroll taxes into account. Payroll taxes, Mr. Chairman, are a very heavy burden on the labor-intensive grocery industry. The acceleration of the social security taxes, for example, for 1984 alone, was estimated to cost our members, the food industry, over $200 million additional for that 1 year. Notwithstanding that heavy cost, our industry took a very forward and progressive attitude toward the financial problems of the social security system. We supported the bill which finally emerged and was signed into law because we understood the need for settling that very important national problem.

But to add a surtax on top of that extremely heavy additional tax load the industry is now paying we believe is too much to ask of this already heavily taxed industry.

Fourth, Mr. Chairman, on page 5, we point out that the food marketing industry is very highly labor-intensive, very highly competitive, very highly productive and a very progressive industry.

We lead the entire world in the ability to distribute and market food. Increased productivity is a byword of this industry.

Our industry has not asked for favorable tax treatment but we do ask for tax fairness.

Fifth, Mr. Chairman, on page 6 we point out that the contingency aspect of the administration's proposal only increases and adds to the problems economically and tax-wise. One basic requirement of any sound tax system is certainty. The whole concept of a tax contingent on a series of unpredictable events and subjective findings 2 or 3 years hence is bad economic and tax policy. With an indefinite tax situation the entire investment climate would be clouded, resulting in a disincentive to make long-term or even short-term investments until the situation stabilized.

Sixth, Mr. Chairman, on page 7 we point out that since budget deficits of great proportions are projected far beyond 1987 under the current predictions, the likelihood is that the tax might very well become permanent. We all know the story of "temporary" taxes. It is highly likely the revenue would be preempted for continued increases in spending. Once in the law, the pressure to continue the tax indefinitely for purely fiscal reasons, the overriding need for revenue, would perhaps prove irresistible.

In conclusion, Mr. Chairman, we think this is the wrong way to go in raising revenue if, indeed, the committee concludes that its only alternative is to, literally, meet the budget target. We believe more efforts should be made to reduce the growth in Government spending before any tax increase is considered. We particularly urge the committee to refrain from hasty action. It would be far more preferable, in our opinion, to wait until the spending picture and the economic situation are clarified before making any decision to impose tax increases anywhere even approaching proposed dimensions.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF JOHN M. MARTIN, JR., ON BEHALF OF THE FOOD MARKETING INSTITUTE

Mr. Chairman and members of the committee, my name is John M. Martin, Jr., I have an office at 1750 K Street, N.W., Washington, D.C. 20006. I am Tax Counsel to the Food Marketing Institute, located at 1750 K Street, N.W., Washington, D.C. 20006, on whose behalf I am appearing before you today.

I appreciate this opportunity to present the views of the Food Marketing Institute in strong and unconditional opposition to the President's proposed contingency corporate and individual surtax, or any modified version thereof, as a means of raising additional revenue.

The Food Marketing Institute (FMI) is a non-profit association that conducts programs in research, education and public affairs on behalf of its 1,100 members—food retailers and wholesalers and their customers in the United States and overseas. FMI's domestic member companies operate over 17,000 retail food stores with a combined annual sales volume of $125 billion—half of all grocery sales in the United States. These member companies vary from small independent operators of one or more grocery stores in a single city to large companies with multiple stores variously located in one state or in a number of states. More than three-fourths of the FMI membership is comprised of independent supermarket operators or small regional firms.

There is some uncertainty about the exact nature of the Administration's proposed surcharge. The budget describes it as "a surcharge on individuals and corporations approximately equivalent to 1 percent of taxable income," while a Treasury Department fact sheet has described it as "a surcharge of 5 percent on taxes paid by individuals and corporations." Subsequent unofficial remarks by Treasury spokesmen have further confused the nature of the proposal as it relates to corporations.

The proposed "contingency" surtax is bad economic policy, bad tax policy—hence bad national policy—and should be summarily rejected. The "contingency" aspect itself is highly questionable, and I will address that briefly later, but let me get right to the main issue: the surtax itself.

A surtax as a percentage of income tax liability of individuals and corporations is an inherently very unfair and inequitable method of raising additional revenue. It presents a number of serious tax policy and economic issues, both as to the individual and corporate aspects. Such a tax would add to the tax burden of those who are currently paying the highest effective rates of tax. It would impose little or no additional burden on those who have high economic income but who, by virtue of the nature of their business and various provisions of the Internal Revenue Code, pay little or no taxes. We are not here questioning the validity of those specific provisions of the Code, nor are we asking that taxes on others be raised, but we simply point out how a surcharge would be highly unfair to the grocery industry.

At the individual level, no matter what its design might be, a surtax increases effective marginal tax rates, thus tending to discourage work, savings, and investment. At the corporate level, a surtax would probably have, as CBO points out, an even greater adverse impact on investment because corporations usually invest large shares of after-tax income. Its highest and most adverse impact is on those businesses and individuals who are already carrying the heaviest load, such as the grocery industry.

The grocery industry is presently paying among the highest effective income tax rates of any industry in the United States. We have examined the published results of several surveys on the subject. In all of these surveys, our industry effective tax rate is shown to be very high relative to other industries. Our own latest annual survey, which we believe to be the most representative and broad based of the surveys we have examined, showed an effective income tax rate for the food marketing industry of 37 percent for 1980–81 and 35 percent for 1981–82.[1] This survey, which has been made annually for several years, is based on a representative sample, covers not only large grocery companies, but companies of various sizes in all sections of the country and is representative of the industry as a whole. We believe it to be reliable. Some of our members pay effective total income tax rates as high or nearly as high as the 46 percent statutory rate. For example, one large company operating in several states, indicated for 1982 a rate of 41 percent; another such multi-state company informally estimates, based on 1st quarter 1983, a rate approaching 46 percent. Many companies are in the range above 35 percent, we believe. In contrast to our overall industry rate, some industries are reported to pay little or no taxes at all or have effective tax rates lower than 10 percent—some negative or lower than 5 percent—although some of them may have high economic income. Thus, it is clear that a surtax based on tax liability is grossly unfair and inequitable to industries such as ours.

Even if the surtax was structured in some form to be "approximately equivalent to 1 percent of taxable income," the result would still be a much heavier total load on those industries already paying high effective rates. It would ignore or increase the differences in effective rates while adding to our total tax load. Without more specific specifications for such an alternative approach, it is not possible to make meaningful comment. For example, what definition of "taxable" income would be intended, and what is meant by "approximately equivalent to," etc.

In this connection, it is important to point out that the acceleration of the payroll taxes contained in the recently enacted Social Security Amendments of 1983 will have a heavy impact on the labor-intensive retail food industry, costing our industry an additional estimated $200 million in 1984. A surtax, however structured, added on top of this already heavy payroll tax increase will increase the cost of business, put pressure on jobs, and thus adversely impact economic recovery, in addition to unfairly impacting the retail industries of the nation. A bigger tax on our thin profit margin leaves less capital in private hands and thus less available for investment and additional jobs. Payroll and other wage-based taxes are not taken into account in studies of effective income tax rates, but they are an increasingly heavy burden on industries such as ours. Moreover, while this is not a federal responsibility, the tax burden on the grocery industry at the state and local level in the form of business taxes, license taxes, occupation taxes, unemployment insurance taxes, etc. is extremely large, and growing larger each year. In this connection, some states have "piggy-back" income taxes, so when federal income taxes increase, the state tax automatically increases.

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[1] This includes in some instances state income taxes, but they are very small amounts compared to the Federal tax.

Mr. Chairman and Members of the Committee, the food marketing industry is very highly labor-intensive, very highly competitive, very highly productive and a very progressive industry. We lead the entire world in the ability to distribute and market food. Increased productivity is a byword in this industry. Laggards lose out very quickly. We hear a great deal about "basic industries" these days. There is no more basic industry in the United States than the marketing and retailing of food. Food, shelter, clothing, and energy of course are absolute economic necessities. Our industry has not asked for selective favorable tax treatment but we do ask for tax fairness. We see no justifiable reason why industries such as ours should be required to shoulder the bulk of the increased tax load while others with lower effective rates, but with high economic income should escape paying their fair share. A surtax would produce just such an unfair result.

The "contingency" aspect of the Administration proposal only increases and adds to the problems, economically and tax-wise. One basic requirement of a sound tax system is certainty. The Administration proposal according to the Budget, would become effective October 1, 1985 only if three conditions are met: "Congress adopts the Administration deficit reduction measures; the unified budget deficit for fiscal year 1986 is forcasted by the Administration, on July 1, 1985, to be above two and one half percent of GNP; and, on July 1, 1985, the economy is growing." The plan would remain in effect for up to 36 months. This set of "criteria"—if it could be called such—is highly subjective, indeed, in our opinion, unworkable in its present form. Obviously, events already require that it be changed. However, looking past this patent difficulty, the whole concept of a tax "contingent" on a series of unpredictable events two or three years hence is bad economic and tax policy. Under such a provision businessmen would have absolutely no idea how much taxes would have to be paid on the returns on investments they might be contemplating. In deciding whether or not to go forward with a project, the anticipated rate of return on the investment may depend heavily on the anticipated tax consequences. With an indefinite tax situation, the entire investment climate would be clouded and there would be a disincentive to make long-term (or even short term) investment decisions until the situation stabilized. The whole tax picture would be highly uncertain. This would be chilling to the economic climate for investment and business expansion and hence destructive of job creation. It is difficult to imagine a more faulty tax policy or economic policy provision to be enacted into the tax law, especially under the existing economic circumstances.

Moreover, since budget deficits of great proportions are projected beyond 1987, should our business community anticipate a continuation of the surtax once it is placed in the Code? We all know the story of 'temporary' tax increases. With such a provision once enacted, it is highly likely the revenue would be preempted for continued increases in spending. Once in the law, the pressure to continue the tax indefinitely for purely fiscal reasons—"the overwhelming need for revenue"—would perhaps prove irresistible.

This is the wrong way to go in raising revenue if, indeed, the Committee concludes that its only alternative is to literally meet the budget target. We believe more efforts should be made to reduce the growth in government spending before any tax increase is considered. We particularly urge the committee to refrain from hasty action. It would be far more preferable, in our opinion, to wait until the spending picture and the economic situations are clarified before making any decision to impose tax increases even approaching proposed dimensions.

Mr. GIBBONS [presiding]. Speaking for myself, I can only say, amen.

Mr. MARTIN. Thank you.

Mr. GIBBONS. Mr. Zegar.

STATEMENT OF DENIS R. ZEGAR, VICE PRESIDENT, GOVERNMENT SERVICES, NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. ZEGAR. Thank you, Mr. Chairman.

I am Denis R. Zegar, vice president, government services for the National-American Wholesale Grocers' Association, NAWGA. I appreciate the opportunity today to address the committee and present the views of the wholesale grocery industry.

I would like to summarize my comments and ask they be entered in the record.

Mr. **Gibbons**. Surely.

Mr. **Zegar**. NAWGA is a national trade association of grocery distribution companies that provides programs and technical, educational, and government services on behalf of its nearly 400 wholesale grocers. NAWGA members operate over 850 distribution centers nationwide, serving independent grocery stores and foodservice establishments throughout the Nation.

NAWGA members' annual sales volume approaches $50 billion, accounting for roughly one-third of the Nation's grocery supply distributed through such centers. NAWGA members employ approximately 250,000 people nationwide.

On behalf of NAWGA, I would like to commend the chairman and the members of the committee for your dedication and commitment to reducing our Nation's ballooning budget deficit of nearly $200 billion.

I would like to add that we have gone through a very, very difficult time. In 1981 the Congress passed ERTA, which many businesses have taken advantage of. ERTA reestablished consumer confidence and assured business that the economy really is on the rebound.

Just as our economy began to expand, Congress passed TEFRA in 1982 and then the Surface Transportation Act of 1983.

The wholesale grocery industry is a very labor-intensive industry and it depends tremendously on transportation to get goods to our customers the retailers.

The Surface Transportation Act increased taxes, for example, from $240 per truck to $1,600 per truck. We have members to whom that means, in dollars, an increase of operating costs of anywhere from a quarter million dollars to over $3 million annually. All this, to an industry that generates after-tax profits of less than 1 percent. There isn't much left to be taxed, much less to be taxed again.

Thus far, business has had to shoulder the burden when it could least afford to do so. Once again we are in a situation of having to increase taxes whereby much of the increase will probably be borne by business.

Mr. Chairman, we cannot afford another tax increase and still do our part to employ more people, build new warehouses, and improve productivity. The net result may be to further jeopardize our economic recovery.

For these reasons, we oppose a 10-percent corporate surtax, whether the tax is temporary or permanent, it will have important macro economic implications. A surtax might be helpful if the economy were expanding in an unsustainable boom but imposed now it might prolong recovery. Corporate surtax would increase marginal tax rates which have an adverse effect on economic incentives and investment behavior.

We also would oppose the lengthening of building depreciation to 20 years.

We also oppose any freeze in the estate and gift tax exemption. We oppose these changes in ERTA mainly because a large majority of NAWGA members are family owned and wish to remain so. Reducing benefits gained under ERTA could jeopardize the future of many smaller wholesale grocers.

As an alternative to reducing the deficit, Mr. Chairman, we urge the committee to consider S. 1627 just recently introduced by Senators Danforth, Boren, and Wallop. The bill is simple and it has been addressed this morning.

For 4 years it redefines indexing for the purpose of Federal Tax Code and for annual COLA's made to non-needs-tested Federal benefit programs. Under the proposal tax indexing would use the CPI 3 percent from 1985 to 1988. The same formula can be applied to not only the Tax Code but to the COLA programs themselves and this would, in fact, increase revenues over the next 4 years of $117 billion according to CBO estimates.

I hope the committee will give serious consideration to this proposal.

Thank you for the opportunity of addressing you today.

[The prepared statement follows:]

STATEMENT OF DENIS R. ZEGAR, VICE PRESIDENT, GOVERNMENT SERVICES, ON BEHALF OF THE NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. Chairman, I am Denis R. Zegar, Vice President, Government Services for the National-American Wholesale Grocers' Association (NAWGA). I appreciate the opportunity today to address the Committee and present the views of the wholesale grocery industry.

NAWGA is national trade association of grocery distribution companies that provides programs and technical, educational and government services on behalf of its nearly 400 wholesale grocers. NAWGA members operate over 850 distribution centers nationwide, serving independent grocery stores and foodservice establishments throughout the nation. NAWGA members' annual sales volume approaches $50 billion, accounting for roughly one-third of the nation's grocery supply distributed through such centers. NAWGA members employ approximately 250,000 people nationwide.

On behalf of NAWGA, I would like to commend the Chairman and the members of the Committee for your dedication and commitment to reduce our nation's ballooning budget deficit of nearly $200 billion. Although a large portion of the national deficit is due to a long and severe recession, which accounted for double-digit inflation, unemployment and interest rates, we must be careful not to kill the goose that may be laying the golden egg. Not enough time has passed to accurately assess the strength of this long-awaited recovery. Passage of ERTA in 1981 did a great deal to help restore consumer confidence and reassure business that the economy is on the rebound. However, just as the economy began to expand, Congress passed TEFRA in 1982 and the Surface Transportation Act of 1983. In both instances, business has had to shoulder the burden when it could least afford to do so. I am certain that these tax increases did more to lengthen the period of total recovery than anything else. Once again, we are in a situation of having to increase taxes whereby much of the increase will be borne by business. Mr. Chairman, we cannot afford another tax increase and still do our part to employ more people, build new warehouses and improve productivity. The net result is to further jeopardize our economic recovery.

With unemployment still near 10 percent and interest rates very high and creeping upward, this is not the time to tax—but, a time to control spending. Controlling spending is urgently needed to avoid increasing taxes at a time when the economy is so fragile.

For these reasons, NAWGA opposes the following revenue options:

10 percent corporate surtax.—Whether the surtax is temporary or permanent, it will have important macroeconomic implications. A surtax might be helpful if the economy was experiencing an unsuitainable boom; but, if imposed under current economic conditions, might actually prolong recovery.

In addition, a corporate surtax would increase marginal tax rates, which would have an adverse effect on economic incentives and investment behavior.

Businesses have already borne the greater share of the additional taxes as a result of TEFRA and the Surface Transportation Act. An immediate revenue increase through a surtax would impose a drag on the private economy, which is still experiencing an economic recession. Though most surtax formulations would impose a levy on firms that are profitable, even those firms have had their profits sharply reduced by the recession. A bigger tax on a smaller profit margin would leave less capital in private hands for financing investment at a time when we need investment and operating capital the most.

Lengthen the building depreciation period to 20 years.—Under ERTA, both new and newly-purchased buildings can be depreciated over 15 years using the 175 declining balance method. The Act also increased tax incentives for investment in equipment, particularly through the ITC. However, in 1982 TEFRA rescinded up to 80 percent of ERTA's incentives for investment in equipment. Further cutbacks in ACRS would severely impede any incentive to modernize existing grocery warehouse facilities because of the high cost of capital and low return on investment.

Freeze estate and gift tax exemption.—NAWGA opposes any changes to ERTA, which substantially reduced taxes on estates and gifts. A large majority of NAWGA members are family-owned and wish to remain so. Reducing benefits gained under ERTA could jeopardize the future of many smaller wholesale grocers.

ALTERNATIVE PROPOSAL

Mr. Chairman, it is not NAWGA's desire to designate certain programs be it defense expenditures or entitlement programs for further budget slashing. However, our ballooning budget deficit must be reduced to insure real and sustained economic growth.

I urge the Committee, on behalf of the National-American Wholesale Grocers' Association to consider S. 1627 introduced by Senators Danforth, Boren and Wallop. The bill is quite simple: for 4 years it redefines indexing for the purposes of the Federal Tax Code and for annual COLA's made to non-needs-tested Federal benefit programs.

Under this proposal, tax indexing would use the factor CPI—3 percent from 1985–88. CBO estimates that this change would result in higher tax revenues of $57 billion during that period.

The other half of the proposal is a temporary change in the annual COLA to Federal non-means-tested benefit programs. Using the same 3 percent formula would result in added revenues of $60.2 billion through 1988. A total savings of $117.2 billion, which would go a long way to balance our huge national deficit. This proposal leaves intact existing programs at current spending levels, but controls future outlays and thus helps to reduce out-year budget deficits.

I hope the Chairman and the Committee will give serious consideration to this proposal. Thank you for the opportunity to address you today.

Mr. **Jenkins** [presiding]. Thank you very much.

Mr. Smith.

STATEMENT OF PHILIP L. SMITH, CHAIRMAN, TAX COMMITTEE, GROCERY MANUFACTURERS OF AMERICA, INC., AND PRESIDENT AND CHIEF OPERATING OFFICER, GENERAL FOODS CORP.

Mr. **Smith**. Thank you, Mr. Chairman.

I am Philip Smith, president and chief operating officer of General Foods Corp. and chairman of the GMA Tax Committee. I am pleased to have this opportunity to appear before the committee on behalf of the Grocery Manufacturers of America, Inc. [GMA], on the subject of raising new revenues. GMA is a trade association of the manufacturers and processors of food and nonfood products sold in retail outlets throughout the United States. Our member companies employ over 2.5 million people and have total annual sales in excess of $200 billion.

It is the position of the GMA that sustaining the economic recovery will provide additional revenue benefit. New or increased business taxes in the next 18 to 24 months would present grave risks to an economy that is performing far below its capacity and is suffering from 10 percent unemployment. Such tax actions should be avoided.

Rather, what is needed at this time is a long-range plan to adjust revenue and Government spending that can bring the budget deficit in line over time. This plan should be the result of careful study but done with such deliberate speed as occurred with the recent bipartisan effort on social security reform. Such a plan should include a simplified and more equitable, efficient tax structure.

It is the demonstration of this resolve and discipline that will most affect the financial markets and lower interest rates. Stopgap tax actions taken in haste will not impress these markets, and other consequences of such actions may in fact have adverse results.

One such action that has been considered is a corporate surtax. GMA is opposed to such a proposal in particular since it magnifies the distortions and inequities already inherent in the corporate tax system. Such a tax would have its greatest impact on labor-intensive industries as well as some faster growing ones and, therefore, would be counterproductive in sustaining economic growth and in providing new jobs.

As this committee is aware, there is great variability in effective corporate tax rates which is not related to profitability, and I have attached to my testimony a copy of material taken from a recent report by the Joint Committee on Taxation to this effect. Grocery manufacturers have tax rates today in the top one-third of industry. This occurs because the tax system is seriously biased in favor of certain types of assets and investments. This can result in investment decisions made primarily for tax purposes and can cause misallocations of capital.

As other studies show, the entire food marketing system, from processor to wholesaler to retailer, pays a high effective tax rate and would be severely affected by the enactment of a surtax. After-tax margins for the total system remain low. No improvement has been possible as food prices have lagged behind the general rate of inflation for 7 of the last 8 years. The impact of a surtax on the grocery industry, therefore, would place an additional cost burden on each step of the food marketing system at a time when margins remain low.

To summarize, the current economic situation can only be hurt by new business tax increases in the next 18- to 24-month period. A long-range economic plan to bring revenues and expenditures in line over time should be our focus. Stopgap revenue measures may well be counterproductive. We are particularly opposed to a corporate surtax which compounds current inequities in the corporate tax system.

On behalf of the member companies of GMA, thank you very much, Mr. Chairman, for permitting me the opportunity to provide this committee with our perspective on this subject of such importance to both our industry and the American consumer.

Thank you.

[The Joint Committee on Taxation table follows:]

TABLE 2.—FEDERAL CORPORATE INCOME TAX RATES OF SELECTED COMPANIES BY INDUSTRY, 1981

[Dollar amounts in thousands]

Industry	U.S. income before tax	Foreign income [1] before tax	Worldwide income [2] before tax	Current U.S. tax expense	Current foreign tax expense [1]	Current worldwide tax expense	U.S. tax rate on U.S. income	Foreign tax rate on foreign income	Worldwide rate on worldwide income
Aerospace	$2,282,317	$473,541	$2,755,858	$155,291	$172,943	$339,834	6.8	36.5	12.3
Beverages	1,186,983	885,719	2,072,702	342,251	346,457	688,708	28.8	39.1	33.2
Chemicals	3,116,500	2,707,400	5,823,900	154,300	1,545,800	1,700,100	5.0	57.1	29.2
Commercial banks	2,050,168	3,274,376	5,312,823	47,975	1,247,677	1,311,036	2.3	38.1	24.7
Crude oil production	996,075	2,470,226	3,887,881	31,043	1,833,019	2,040,988	3.1	74.2	52.5
Diversified financials	1,653,911	238,357	2,282,168	277,816	93,645	399,161	16.8	39.3	17.5
Diversified services	1,714,074	951,309	2,522,970	507,179	319,152	693,958	29.6	33.5	27.5
Electronics, appliances	4,551,281	1,703,692	6,222,036	1,335,269	722,004	2,131,060	29.3	42.4	34.3
Food processors	2,809,725	905,571	3,715,296	752,603	458,973	1,211,576	26.8	50.7	32.6
Industrial and farm equipment	1,594,768	438,395	2,033,163	383,574	177,167	560,741	24.1	40.4	27.6
Metal manufacturing	2,557,389	329,755	3,297,944	249,680	115,820	382,000	9.8	35.1	11.6
Motor vehicles	1,188,694	468,088	1,099,982	566,704	456,299	240,103	47.7	97.5	21.8
Office equipment	4,327,124	2,877,055	7,204,179	1,093,007	1,725,520	2,818,527	25.3	60.0	39.1
Oil and refining	21,489,584	19,737,334	47,638,253	4,003,997	11,913,965	18,092,162	18.6	60.4	38.0
Paper and wood products	1,354,143	197,959	1,552,102	(192,877)	57,339	(135,538)	(14.2)	29.0	(8.7)
Pharmaceuticals	1,692,049	1,280,600	2,972,649	606,782	619,915	1,176,697	35.9	48.4	39.6
Retailing	2,365,877	301,268	2,621,145	536,268	123,822	642,090	22.7	41.1	24.5
Tobacco	2,593,421	536,340	8,129,761	811,881	110,678	922,559	31.3	20.6	29.5
Transportation:									
Airlines	239,571	95,635	326,374	38,533	25,800	57,469	16.1	27.0	17.6
Railroads	1,723,273	([3])	1,723,273	(129,434)	([3])	(129,434)	(7.5)	([3])	(7.5)
Trucking	796,654	10,826	795,395	367,550	5,183	372,733	46.1	47.9	46.9
Utilities	15,375,821	204,521	16,202,651	1,417,224	83,024	1,514,037	9.2	40.6	9.3

[1] Foreign income as disclosed in the financial statements may not reflect an allocation between foreign and domestic income that is consistent with U.S. tax rules. Current foreign tax expense may include amounts which are not creditable foreign taxes for purposes of the foreign tax credit under the applicable U.S. tax rules. for this and other reasons (such as foreign currency translation gains and losses), the foreign tax rate may not be comparable with the U.S. tax rate.

[2] Worldwide income is not necessarily the total of U.S. income and foreign income because some companies do not disclose foreign earnings and because losses are excluded from group totals. Thus, the worldwide tax rate does not necessarily fall between the U.S. and foreign tax rates.

[3] Not available.

Source: Joint Committee on Taxation.

Mr. **Jenkins**. Thank you very much, Mr. Smith, for your excellent testimony.

Ms. Campbell.

STATEMENT OF JEANNE CAMPBELL, VICE PRESIDENT, WASHINGTON OFFICE, THE NEW ENGLAND COUNCIL, INC. ON BEHALF OF STEVE PULEO, CHAIRMAN, TAX COMMITTEE

Ms. **Campbell**. Thank you, Mr. Chairman.

I am Jeanne Campbell, vice president of the New England Council, Inc., substituting for Mr. Puleo, who was not able to be here today. But nonetheless, I am very happy to be with you.

I would like to thank the chairman and the members of the committee for giving the council an opportunity to present its views, and I also ask that our testimony be made a part of the record. My remarks will simply highlight that testimony.

The council represents a wide range of business interests in New England. Our membership of over 1,200 companies employs one-sixth of the working population of the region. They are engaged in banking, insurance, education, utilities, petroleum, and tourism, to name just some. We are a diverse group, but we all use energy. In New England imported oil accounts for 74 percent of that energy use.

Energy is a survival issue for us. We are concerned about an oil import fee, and even if it is no longer part of the administration's plans, the fee seems to have nine lives, does not lie still, and will no doubt surface again.

Such a fee would jeopardize the economic recovery we all seek. A fee of this kind is regionally inequitable, inflationary, and noncompetitive, and we urge this committee to strongly reject such a proposal.

The council believes an oil import fee is bad tax policy and bad energy policy. It is devastating to us, placing a disproportionate burden on a region already paying higher costs for energy.

The Nation is hurt by an oil import fee as well. A $5 per barrel fee would require consumers to pay between $3 and $6 worth of price and cost increases in the economy for every $1 in net Government revenue.

A fee would fuel higher unemployment and dampen the fires of economic revitalization just beginning to flicker in a time when Americans are beginning to realize some benefits of cheaper imported oil, lower energy costs, and a somewhat livable Consumer Price Index.

I would also like to share with you the council's tax policy which reflects the thinking of a cross-section of New England business leaders. The council's policy calls for, one, substantial reductions in spending for entitlements and discretionary programs including defense and nondefense items. Two, both revenue raising and spending cuts should be broad based and equitable. The council favors adoption of nondiscriminatory consumption oriented revenue raising system with incentives for investing. And we favor consideration of a value-added tax.

However, I might point out that the council's members don't have to run for reelection.

As a final comment, we realize your task is very difficult. Deficits are not removed by magic. We ask that in your deliberations you consider taxes that are fair to all Americans which is something an oil import fee is not.

Thank you.

[The prepared statement follows:]

STATEMENT OF STEVE PULEO ON BEHALF OF THE NEW ENGLAND COUNCIL

SUMMARY

The New England Council, Inc., is a 58-year-old independent, non-profit association of 1200 businesses in the New England region. The Council's member firms collectively employ over one million New Englanders.

The Council strongly opposes an oil import fee because it is inflationary, inefficient and the least equitable way to raise tax revenues necessary to reduce the federal deficit.

In the Council's view, an oil import fee, which is part of the Administration's contingency tax plan included in the President's FY 1984 budget, would create severe economic and social hardships, particularly in New England, a region heavily reliant on imported oil.

Of particular concern to the Council is the dampening effect an oil import fee would have on the economy that is just beginning to show some clear signs of revitalization.

In addition, the Council support sound fiscal policy by the federal government and believes that no effort to reduce deficits can succeed without substantial reductions in spending for defense and non-defense items.

STATEMENT

Mr. Chairman and members of the committee, my name is Steve Puleo. I am the Chairman of the New England Council, Inc. Tax Committee, a Director of the Council and the Partner-In-Charge of the New England Regional Office of Coopers and Lybrand. I wish to thank Chairman Rostenkowski and the Members of the Ways and Means Committee for this opportunity to present the views of the New England Council with regard to contingency taxes and revenue raising proposals.

The Council is unique in its role as the only association which represents a wide range of business interests in the New England area. With a membership of over 1200 companies employing 1 million people (⅙ of the employed workers in the region), we have a keen interest in any revenue increase proposals. While we strongly advocate reducing the federal deficit, which is crucial to long-term economic recovery, we believe that any tax legislation should be both progressive and regionally equitable. However, the New England Council is deeply concerned that the Administration and some Congressional leaders are considering the imposition of a contingency tax which places an import fee on crude oil and refined petroleum products as a means of raising revenue. Such a fee would seriously jeopardize the economic recovery sought by Congressional leaders.

In addition, a tariff of this sort is regionally inequitable, inflationary, non-competitive and regressive, and we urge this Committee to reject such a policy proposal. My testimony today details two areas which I will highlight in my brief comments. (1) The overall negative effect on the nation of an oil import fee, and the particularly onerous burden of such a fee on the one region of the nation for which petroleum issues are a matter of survival. (2) The New England Council's current tax spending policies that represent the views of a major cross-section of the region's business leadership.

National and regional effects of an oil import fee

Nationally, a $5 per barrel import fee would deprive the economy of the beneficial effects of the recent decline in oil prices; it would stifle a fledgling recovery that should be nurtured not injured. An oil import fee is bad energy policy, bad tax policy and bad economics for the nation. But the situation is even worse for New England, where bad policy becomes disastrous policy. Simply put, an oil import fee imposes a disproportionate burden on the region. A $5 per barrel fee would force residents and companies of our six-state region to pay some $1.9 billion extra in consumer petroleum costs ($380 million for each $1 per barrel fee) or 12–15 cents per gallon in higher heating, transportation and manufacturing costs.[1] Those of us who live and work in America's frost belt already pay a higher than average cost for energy. In short, an oil import fee is an unfair tax on a basic necessity of life for many Americans.

Ultimately such a fee amounts to a kind of self-imposed OPEC that hurts American consumers whose hopes for an economic revival are just beginning to bud. In recent years American consumers and business have practiced conservation—pulled in the energy belt-buckle—and assidously pursued a course leading to a greater degree of energy independence. In spite of political instability in many oil rich nations and dangerous periods of rising oil prices in the world markets, Americans still looked forward to a time when energy could become reasonably affordable.

With the recent welcome drops in world oil prices, we could finally experience a sense of relief. The imposition of an oil import fee now would simply take us back to this recent past when paying for oil became nearly impossible for many Americans.

Effects on consumers and business

With an oil import fee, consumers will pay between $3 to $6 worth of price and cost increases throughout the nation's economy for evey $1 in net government revenue.[2] Our many energy intensive industries will suffer as well in a region that is 74 percent dependent on imported oil. As costs go up, so will unemployment since manufacturers will limit production in order to cope with new energy price demands. Thus, an oil import fee will fuel higher unemployment and dampen the fires of industrial revitilization just when Americans are beginning to realize the benefits of cheaper imported oil, lower energy costs and a liveable consumer price index.

The $5 per barrel tariff will also have a pernicious effect on competition, both nationally and internationally. The fee will serve to alter the competitive structure and relationship in domestic and international trade when this nation must compete with countries not subject to an import fee. A healthy market place is a goal of Congress and the Administration. A fee that shackles American business in the arena of world trade is not a way to achieve that goal.

Arguments that this tax would stimulate domestic production and curb the consumption of imported oil are flawed. American consumers will pay virtually all of the import fee in addition to the 5 cents per gallon gas tax imposed by earlier legislation. In addition, domestic oil price hikes and increases for imported oil have, historically, operated in tandem, and there is no reason to think this oil import fee would behave differently. A recent Congressional Research Service Report states that "crude oil and other components of domestic supply would rise in parallel with the fee increment on imports." The fee effectively blunts the competitive edge of New England, with its high concentration of exporting industries. Also, the nation's ability to limit the trade deficit is greatly impaired.

In April of 1982 the Congressional Budget Office determined that a $5 per barrel fee would increase gross revenues by $10 billion in fiscal year 1984 and would result in increased revenues of $8.1 billion from the windfall profit tax and $5.8 billion from corporate income taxers paid by domestic oil producers.[3] But this projected revenue gain is exceedingly deceptive in view of the impact of the oil import fee of $5 per barrel on inflation which would increase by nearly one percentage point. In addition a $5 per barrel fee would create a loss in the gross national product of about $30 billion.[4] These effects on the economy would result in a loss of revenue to the Treasury of corporate and personal income tax of $4.2 billion from non-petroleum sectors of our economy.[5] Increased federal revenues would be further offset by increases in social security payments, entitlement program expenditures, such as food stamps, supplemental security income, federal retirement and other programs which are adjusted for the inflation that would rise from the fee's inflationary impact. These losses are in addition to the increased unemployment that would result from an oil import fee—31,000 more unemployed in 1983 and 96,000 more in 1984 [6]—and, of course, increased unemployment means increased unemployment compensation. These figures suggest that revenue gains from an oil import fee are not sound fiscal or social policy.

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[1] Based on State Energy Data Report, Department of Energy, September 1981.

[2] New England Fuel Institute, statement of policy, Apr. 21, 1982.

[3] Congressional Budget Office, "Oil Import Tariffs: Alternative Scenarios and Their Effects," Apr. 1982.

[4] Petroleum Industry Research Foundation, Inc., "The Oil Import Fee Issue," Apr. 19, 1982.

[5] The Congress of the United States, Congressional Budget Office, "Oil Import Tariffs: Alternative Scenarios and Their Effects," Staff Working Paper, Apr. 1982.

[6] Gelb, Bernard A. and Hull, Everson W., Congressional Research Service, The Library of Congress, "Revenue and Macroeconomic Impacts of an Oil Import Tax: A Brief Review," Washington, D.C., Apr. 6, 1982.

Indeed, when the social and economic costs of this policy are weighed against the potential revenue gain, the tariff seems unwarranted. The very burdens which our government has tried to lift (inflation, unemployment, retarded economic growth and high interest rates) are exacerbated by this contingency tax.

New England council tax policy position

In addition, I would like to offer some suggestions for possible tax proposals and modifications that have been adopted by the New England Council, Inc.

In the Council's view the solution to a true long-term structural deficit problem should be resolved by a broad based program which is sound, achievable and economically equitable. A measure such as the oil import fee does not raise the desired revenue without incurring intolerable economic and social costs.

Mr. Chairman, The New England Council, Inc. would like to suggest that this Committee meet the need to raise immediate revenue by means of simple across the board tax during this session of Congress. Then next year go back, in a sense to "the drawing board," and redesign legislation that is broad based and equitable in order to raise additional revenue.

Pursuant to this end, we would like Congress to consider the adoption of a nondiscriminatory consumption oriented revenue raising system which has as part of its underlying philosophy incentives for saving and investing while increasing revenue by taxing expenditures. Such a system has an added benefit of ease of administration.

The Council also recommends that Congress undertake a program to review and examine the revenue raising system with tax reform as one of the objectives along with determining what other taxation concepts might be adopted to increase the tax base.

Such tax reform must recognize and link national economic goals with revenue raising and expenditure policy, keeping in mind the objectives of the social welfare of its citizens and providing business with the necessary economic incentives to produce goods and services. As with any tax reform, the underlying concept should be simplicity and integrity.

In addition, the Council has concluded that the Administration's contingency plan, with a reliance on a corporate income tax surcharge, does not adequately address the basic structural causes of future deficits.

In conclusion, Mr. Chairman, and speaking for the Council I would urge the Committee to consider the adverse social and economic ramifications of an oil import tariff when making its final decision on revenue raising proposals. There are few taxes that would do more damage to the economy.

The financial impact on American consumers might easily create an energy price shock near the magnitude of the 1973 OPEC oil embargo and the Iranian crisis of recent years.

In addition, the fee would stymie the quickening economic recovery that according to Treasury Secretary Regan was stimulated by the recent reduction in oil prices.

Mr. Chairman, The New England Council, Inc. urges that you reject an oil import fee and respectfully requests your consideration of its tax policy positions which I briefly outlined and which are incorporated in our written testimony.

I would also like to include in this record a "Dear Colleague" letter that was distributed last year by Congressman Conte and Dingell. This letter raises pertinent points and clearly reaffirms points made about the hardships imposed by an oil import fee. Thank you.

APRIL 1, 1982.

DEAR COLLEAGUE:

As the Administration contemplates negotiating the details of its budget proposal with the Congress, discussions regarding a "quick fix" solution to reduce the projected budget deficit persist. One such proposal being considered is an onerous oil import fee. We urge you to support a Resolution, to be introduce by Congressman Conte when the Congress returns, which opposes the imposition of an import fee on crude oil and refined products.

An oil import fee of $5 or $10 per barrel will raise the price of not only necessities, such as home heating oil and gasoline, but its impact will reverberate throughout all sections of our economy—housing, automobile, agriculture, tourism, etc. A fee applied to oil imports will also raise the price of domestic crude oil and products. According to a recent Congressional Research Service report, "Conventional wisdom holds that liquid domestic hydrocarbon supply tracks the price of imported crude closely. If this is the case . . . crude oil and other components of domestic supply would rise in parallel with the fee increment on imports." In fact, the report continues by estimating that the oil companies will reap another $15 billion in after-tax profits in 1983 with a $5 per barrel fee; twice that amount with a $10 fee.

The report projects that with a $5 fee there will be an increase of more than $30 billion in the nation's oil bill in the first year of imposition. This translates into 11.5 cents per gallon increase to the consumer. Unemployment is also expected to rise; by 1984, 96,000 additional workers would be without jobs with the $5 per barrel fee, 185,000 additional workers unemployed with a $10 fee. Such a fee will drain the economy of its purchasing power and retard its recovery. As evidenced by the following figures, this clearly is not a regional issue:

Annual impact of oil import fee—$5/barrel

[1979 consumption figures]

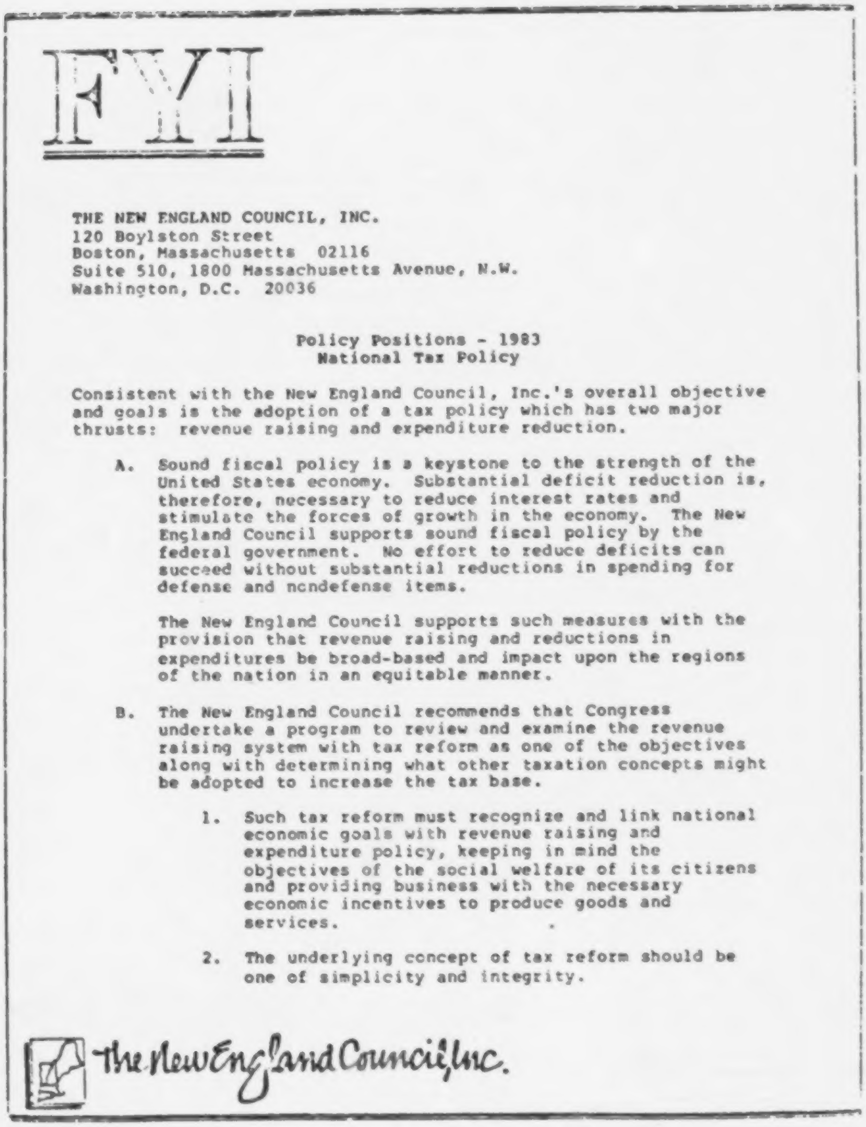
	Billions
New England	$1.9
Mid Atlantic	4.9
South Atlantic	5.1
East North Central	5.3
West North Central	2.6
East South Central	2.2
West South Central	5.6
Mountain	1.7
Pacific	4.4
United States total	$33.8

It should be noted that any unilateral imposition by the Administration of such an import fee as a revenue-raising measure is in violation of Section 232 of the Trade Expansion Act. (Under the Act, the President may only impose the fee if our national security is at stake; this is not the case here). It is interesting that the CRS study projects that while a $5/$10 per barrel tax will cause such hardship, it will only reduce the deficit by $3.5/$6.8 billion in 1983; it will, however, increase the deficit by $5/$9 billion in 1984.

It is painfully obvious that there are other more progressive and less-onerous revenue-raising options available. We find it unconscionable to levy this regressive tax on individuals and businesses at a time when they are enduring this current economic recession.

Sincerely,

Silvio O. Conte.
John D. Dingell.



FYI

THE NEW ENGLAND COUNCIL, INC.
120 Boylston Street
Boston, Massachusetts 02116
Suite 510, 1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Policy Positions - 1983
National Tax Policy

Consistent with the New England Council, Inc.'s overall objective and goals is the adoption of a tax policy which has two major thrusts: revenue raising and expenditure reduction.

A. Sound fiscal policy is a keystone to the strength of the United States economy. Substantial deficit reduction is, therefore, necessary to reduce interest rates and stimulate the forces of growth in the economy. The New England Council supports sound fiscal policy by the federal government. No effort to reduce deficits can succeed without substantial reductions in spending for defense and nondefense items.

The New England Council supports such measures with the provision that revenue raising and reductions in expenditures be broad-based and impact upon the regions of the nation in an equitable manner.

B. The New England Council recommends that Congress undertake a program to review and examine the revenue raising system with tax reform as one of the objectives along with determining what other taxation concepts might be adopted to increase the tax base.

1. Such tax reform must recognize and link national economic goals with revenue raising and expenditure policy, keeping in mind the objectives of the social welfare of its citizens and providing business with the necessary economic incentives to produce goods and services.

2. The underlying concept of tax reform should be one of simplicity and integrity.

The New England Council, Inc.

3. Public policy surrounding national tax standards and mechanisms needs to be responsive to the need to raise levels of investment in plant and equipment and reduce barriers and constraints to productive investment and personal savings.

Specific Concepts

A. Expenditure Tax

Congress should consider the adoption of a nondiscriminatory consumption oriented revenue raising system which has as part of its underlying philosophy incentives for saving and investing while increasing revenue by taxing expenditures. Such a system has an added benefit of ease of administration.

B. Savings

Deductions for savings should be allowed for a percentage of earned income when such savings can be demonstrated to contribute to the capital of the nation. Recognized and easily monitored vehicles such as savings accounts and IRAs could be used for such capital accumulation.

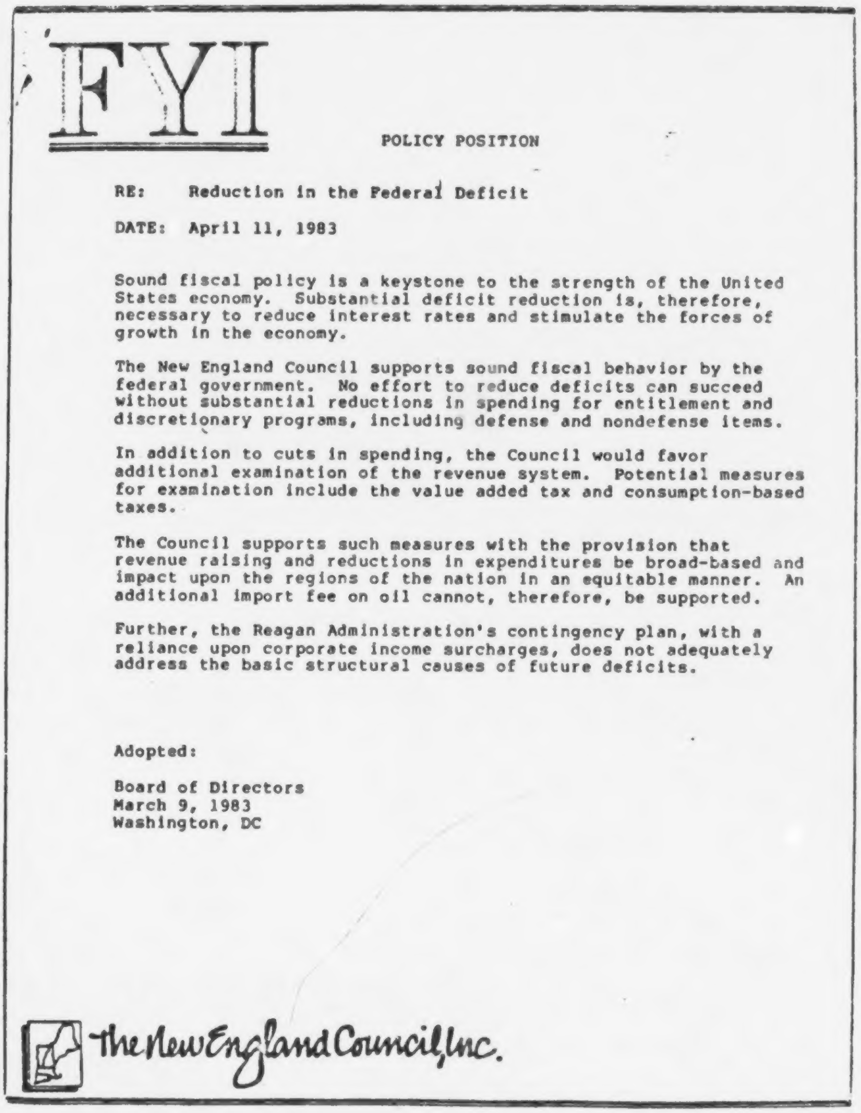
C. Incentives for Capital Investment

1. To ensure continued innovation and economic growth, Congress should adopt a permanent and simplified R&D tax credits. For example, eliminate the 861-8 allocation of R&D expenditures to specific income.
2. Congress should adopt measures to provide national industries with sufficient tax incentives to produce goods and services in the United States, while remaining competitive in worldwide markets. Such incentives should include a foreign tax credit, a DISC replacement and an export incentive corporation.
3. The federal capital gains holding period should be reduced from one year to six months. The shorter holding period will increase the mobility of capital and assure a more efficient allocation of such funds to sources of growth and expansion within the economy.
4. Adopt an integrated corporate/individual tax system by allowing deductions to corporations for dividends paid to shareholders.

D. Investment in Human Capital

In order to enhance and protect the skills of the nation's workforce Congress should provide further tax incentives to stimulate investment by individuals and industry in education, training and retraining.

Adopted: June 14, 1983



FYI

POLICY POSITION

RE: Reduction in the Federal Deficit

DATE: April 11, 1983

Sound fiscal policy is a keystone to the strength of the United States economy. Substantial deficit reduction is, therefore, necessary to reduce interest rates and stimulate the forces of growth in the economy.

The New England Council supports sound fiscal behavior by the federal government. No effort to reduce deficits can succeed without substantial reductions in spending for entitlement and discretionary programs, including defense and nondefense items.

In addition to cuts in spending, the Council would favor additional examination of the revenue system. Potential measures for examination include the value added tax and consumption-based taxes.

The Council supports such measures with the provision that revenue raising and reductions in expenditures be broad-based and impact upon the regions of the nation in an equitable manner. An additional import fee on oil cannot, therefore, be supported.

Further, the Reagan Administration's contingency plan, with a reliance upon corporate income surcharges, does not adequately address the basic structural causes of future deficits.

Adopted:

Board of Directors
March 9, 1983
Washington, DC

The New England Council, Inc.

Mr. HANCE [presiding]. Thank you.

Next we have Mr. Blum.

STATEMENT OF JACK A. BLUM, GENERAL COUNSEL, INDEPENDENT GASOLINE MARKETERS COUNCIL

Mr. BLUM. Thank you, Mr. Chairman.

I am Jack A. Blum. I am the general counsel of the Independent Gasoline Marketers Council, a trade association of nonbranded independent retailers of motor gasoline. I am here with a revenue-raising proposal.

We believe this committee should include language which legislatively redefines the method used for calculating windfall profit tax due from the producers of Alaskan North Slope crude as a revenue-raising provision in this year's tax bill.

We believe that at least one of the North Slope producers has taken unfair advantage of ambiguities in the existing code sections relating to the windfall profits tax and has underpaid the tax by a significant amount.

The company, Arco, has used this unintended tax benefit to finance an anticompetitive campaign which will destroy independents who compete in Arco's market.

Normally, one would say that this underpayment is a matter between the IRS and the taxpayer which should be resolved in the audit process and is not a proper subject for public discussion.

In this case, the audit process will be totally ineffective. The size of the underpayment is so large and so company-specific that the failure to collect tax on an equitable basis has injured large numbers of innocent bystanders. The injury will continue until the inequity is corrected.

In the normal course of business, windfall profit tax audits are at best slow. We believe that IRS is just beginning the process of challenging the first of the returns which were filed in 1980.

Because the law is somewhat unclear and because Treasury has failed to clarify it in a timely fashion with regulations or a proclamation, a challenge to the returns of Alaskan producers made by IRS will, without question, be contested.

Resolution of the contested claims would likely be by compromise reached in 1986 or 1987, long after the competitive damage has been done and, lest you question the competitive damage, the two largest independent refiners in California, Tosco and Powerine, are on the brink of bankruptcy.

We believe that the issue must be resolved now by legislation as a matter of equity among competitors.

There is a second point which this committee should not overlook, a resolution of these issues will raise a substantial amount of revenue this year.

Put simply, a windfall profit tax issue is an intracompany transfer price problem. Windfall profits taxes are assessed on the difference between removal price at the wellhead and the old predecontrol price. Removal price in most cases is the market price.

Inasmuch as no Alaskan oil is sold at the wellhead and there are very few clean third-party transactions because the North Slope producers are virtually integrated, the process by which the removal price is calculated for that crude is a matter of subtraction.

The companies take the price of crude in an end market and subtract the cost of transporting the crude to the end market. The problem is that the price of transportation is under the control of the producers.

They own the pipeline, and in the case Arco, they also own the tankers. The end market prices are a matter of debate because Arco transfers the crude to its own refineries and, therefore, there is no arm's-length sales price at all.

We believe, despite Arco's protestations to the contrary, that they have misapplied the existing law. They say that the windfall tax on all their Alaskan production should be based on the gulf coast price of equivalent crudes less transportation to the gulf coast.

They make this claim in their own refineries on the west coast and transportation to the west coast is substantially cheaper.

According to testimony before the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, using this methodology saved Arco $244 million last year.

Exxon and BP do not use the same method, but rather base their payments on freight to the oil's actual destination.

Our analysis of the Alaskan tax issue has convinced us that this committee should reexamine the assumptions it made when the windfall profit tax was originally passed.

Alaskan oil is now more than 20 percent of the domestic supply and its production and sale is dominated by three companies which have found it to be immensely profitable.

In retrospect, Congress should have challenged the claim that the Alaskan fields involved high risk and great cost and, therefore, deserved special tax treatment. Records should have been subpenaed and financial information examined.

Now, this committee should ask whether the structure of the existing law allows the companies to double-count their high costs and, therefore, receive double tax benefits.

We have a second problem, and I will skip to that problem because time is short. Arco is the only North Slope producer to own its own Jones Act tanker fleet which moves crude oil from Valdez to the lower 48. The charter rates are protected from foreign competition by law.

As I said before, Arco is charging itself a high noncompetitive freight rate based on the protected charter rates and is subtracting the high rate from the market price to lower the removal price.

Adding insult to injury, they are also using a Treasury ruling to get the shipping income treated as foreign source income to the extent the ships are outside U.S. territorial waters. Thus, the revenue from American-flag ships is foreign for all but 6 miles of a 5,000-mile voyage.

The ruling enables the company to move money sheltered from windfall profit tax and Alaska State royalty payments out of the U.S. tax system altogether and to offset it against foreign tax credits and other charges.

TEFRA closed this loophole for new tankers, but did not close it for the existing fleet, Arco owns much of the existing fleet. We believe that equity demands the loophole be closed for the ships in service before 1981.

For the committee's information, I have attached a copy of my testimony before the House Energy and Commerce Oversight and Investigations Subcommittee and a copy of the revenue ruling on ship charters to which I made reference.

These proposed changes, would, as I said earlier, raise significant amounts of revenue, save thousands of small and independent businesses and end glaring inequity in the Tax Code which benefits a very few major oil companies.

[The prepared statement follows:]

STATEMENT OF JACK A. BLUM, ON BEHALF OF INDEPENDENT GASOLINE MARKETERS COUNCIL

My name is Jack A. Blum. I am the General Counsel of the Independent Gasoline Marketers Council, a trade association of nonbranded independent retailers of motor gasoline.

IGMC believes that this Committee should include language which legislatively redefines the method used for calculating windfall profits tax due from the producers of Alaskan North Slope crude as a revenue raising provision in this year's tax bill.

We believe that at least one of the North Slope producers has taken unfair advantage of ambiguities in the existing Code sections relating to the windfall profits tax and has underpaid the tax by a significant amount. The company, Arco, has used this unintended tax benefit to finance an anticompetitive campaign which will destroy independents who compete in Arco's market.

Normally, one would say that this underpayment is a matter between the IRS and the taxpayer which should be resolved in the audit process and is not a proper subject for public discussion. In this case, the audit process will be totally ineffective. The size of the underpayment is so large and so company specific that the failure to collect tax on an equitable basis has injured large numbers of innocent bystanders. The injury will continue until the inequity is corrected.

In the normal course of business, windfall profits tax audits are at best slow. We believe that IRS is just beginning the process of challenging the first of the returns which were filed in 1980. Because the law is somewhat unclear and because Treasury has failed to clarify it in a timely fashion with regulations or a proclamation, a challenge to the returns of Alaskan producers made by IRS will, without question, be contested.

Resolution of the contested claims would likely be by compromise reached in 1986 or 1987, long after the competitive damage has been done and, lest you question the competitive damage, the two largest independent refiners in California, Tosco and Powerline, are on the brink of bankruptcy. We believe that the issue must be resolved now by legislation as a matter of equity among competitors.

There is a second point which this Committee should not overlook—a resolution of these issues will raise a substantial amount of revenue this year.

Put simply, the windfall profits tax issue is an intracompany transfer price problem. Windfall profits taxes are assessed on the difference between "removal price" at the wellhead and the old pre-decontrol price. "Removal price" in most cases is the market price.

Inasmuch as no Alaskan oil is sold at the wellhead and there are very few clean third party transactions because the North Slope producers are vertically integrated, the process by which the "removal price" is calculated for that crude is a matter of subtraction. The companies take the price of crude in an end market and subtract the cost of transporting the crude to the end market. The problem is that the price of transportation is under the control of the producers. They own the pipeline, and in the case of Arco, their own tankers. The end market prices are a matter of debate because Arco transfers the crude to its own refineries and, therefore, there is no arms length sales price.

We believe, despite Arco's protestations to the contrary, that they have misapplied the existing law. They say that the windfall tax on all their Alaskan production should be based on the Gulf Coast price of equivalent crudes less transportation to the Gulf Coast. They make this claim despite the fact that they refine most of their crude in their own refineries on the West Coast and transportation to the West Coast is substantially cheaper.

According to testimony before the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, using this methodology saved Arco $244 million last year. Exxon and BP do not use the same method, but rather base their payments on freight to the oil's actual destination.

Our analysis of the Alaskan tax issue has convinced us that this Committee should re-examine the assumptions it made when the windfall profits tax was originally passed. Alaskan oil is now more than 20 percent of the domestic supply and its production and sale is dominated by three companies which have found it to be immensely profitable.

In retrospect, Congress should have challenged the claim that the Alaskan fields involved high risk and great cost and, therefore, deserved special tax treatment. Records should have been subpoenaed and financial information examined. Now this Committee should ask whether the structure of the existing law allows the companies to double count their "high costs" and, therefore, receive double tax benefits.

For example, Congress assumed that transportation costs are high and, therefore, the Alaskan producers should be able to lower the "removal price" by the transportation charge. But once that assumption was made, Congress should not have set the base price of the oil for purposes of the tax calculation with lower tier oil. The old price should have been much lower because of high transportation cost which made the oil less valuable. In effect, the way the tax was structured, the Alaskan producers had their cake and ate it too.

I know the Alaskan producers have invested a lot of money in advertising and public relations to convince you that they are worthy of public largess. Alaska is cold in the winter and remote, but the truth is that Alaskan crude is one of the cheapest crude streams in the country on a fully amortized basis. Financial analysts believe that when all expenses, including amortization, are taken into account the oil costs $1.50 a barrel. That compares to $16 a barrel for California heavy and $20-$24 for newly discovered oil in Illinois, West Virginia and Oklahoma.

The TAPS pipeline was expensive and perhaps overpriced at $9.4 billion. But at present rates, the line is generating close to $4 billion a year in revenue. The TAPS rate is theoretically subject to FERC rate regulation, but FERC has yet to do anything in the way of real regulation. The TAPS case is still pending and will likely be pending when everyone in this room has retired and in the meantime, the owners post whatever rate they want to charge.

Independent marketers are, therefore, competing on the street against a misguided government subsidy and against at least one company which is interpreting the law to maximum advantage. Many of these independent marketers have faced Arco retail prices for gasoline which are lower than the laid in cost of crude oil at their suppliers' refineries. Arco's retail prices for gasoline have stayed well below wholesale prices charged by other suppliers. ARco has made money in quarters when the higher priced suppliers lost it. Hundreds of independents have gone under as Arco's federally funded program of predation has continued.

Our message to you is a simple one: If you meant to subsidize Alaskan production to encourage more, rewrite the law to keep the subsidy in Alaska and away from driving independents under. If the intent was different, recognize the damage that is being done and correct it. End the double benefit and rethink the issue.

As a remedy for the transfer price problem, we propose that the removal price for Alaskan crude be established as a matter of law by the arms length market price at the nearest refining center, less transportation to that center at cost. In the event there is no market price for the crude because the oil is transferred within the same company, the crude price should be the laid in cost of an equivalent foreign crude at the same refinery. That is a standard reference price in the industry and well within the ability of IRS to ascertain.

A second tax issue involving Arco is worthy of mention. Arco is the only North Slope producer to own its own Jones Act tanker fleet which moves crude from Valdez to the lower 48. The charter rates are protected from foreign competition by law. As I said before, Arco is charging itself a high noncompetitive freight rate based on the protected charter rates and is subtracting the high rate from the market price to lower the "removal price."

Adding insult to injury, they are also using a Treasury ruling to get the shipping income treated as "foreign source income" to the extent the ships are outside U.S. territorial waters. Thus, the revenue from American flag ships is "foreign" for all but six miles of a 5,000 mile voyage.

The ruling enables the company to move money sheltered from windfall profits tax and Alaska state royalty payments out of the U.S. tax system altogether and to offset it against foreign tax credits and other charges.

TEFRA closed this loophole for new tankers, but did not close it for the existing fleet, Arco owns much of the existing fleet. We believe that equity demands the loophole be closed for the ships in service before 1981.

For the Committee's information, I have attached a copy of my testimony before the House Energy and Commerce Oversight and Investigation Subcommittee and a copy of the revenue ruling on ship charters to which I made reference.

These proposed changes, would, as I said earlier, raise significant amounts of revenue, save thousands of small and independent businesses and end glaring inequity in the tax code which benefits a very few major oil companies.

[Attachment]

STATEMENT OF JACK A. BLUM, ON BEHALF OF INDEPENDENT GASOLINE MARKETERS COUNCIL[1]

My name is Jack Blum. I am the General Counsel of the Independent Gasoline Marketers Council a trade association of independent retailers of motor gasoline.

The members of my association are being systematically destroyed by a combination of IRS failure to collect windfall profits taxes, and blatant violations of the antitrust laws by major companies which in any other administration would have led to immediate enforcement action by the Justice Department and the Federal Trade Commission.

In the last two years, more than a dozen large marketers have sold out, liquidated or drastically curtailed operations. Names which were associated with brilliant enterpreneurial skill now exist only as a division of a larger corporation to the extent they exist at all. Gibbs Oil sold to Sohio, Mercury to Northeast and Northeast to Charter. Scotland was sold to Publix. Lehigh was liquidated. South Central is now part of Delta Refining and Sigmor is part of Diamond Shamrock.

Many of the companies which were not sold are up for sale. More than a half-dozen of the remaining large independents can be purchased at distressed prices.

These companies are not failing because of inefficiency, failure to modernize, or failure to invest. They pioneered low overhead, high volume gasoline retailing. They can still move a gallon of gasoline from the refinery gate to your car for less money than anyone else in the industry.

By every measure of economic efficiency they should be the survivors in the fight for survival that declining demand and falling prices have created. But they are not surviving and that is because major oil companies, Altantic Richfield in particular, are selling finished gasoline at the retail pump for less than the cost of competing crude oil in the same location.

No amount of efficiency on the part of a retailer will make up for a negative spread between his supplier's crude oil costs and his competitor's street price. As long as crude oil at the refinery costs more than gasoline on the street every independent refiner and marketer who buys, rather than produces crude oil and every marketer who buys product is slated for extinction.

Although the situation is difficult across the nation, it is especially bad in markets where Atlantic Richfield has embarked on a systematic campaign to eliminate independent competition. These markets are the entire West Coast including Arizona, and the Northeastern markets, especially Pennsylvania and Massachusetts.

I accuse Atlantic Richfield of this systematic campaign targeted against independents because no other explanation makes sense. The company began its campaign with an announcement last May that it was giving up credit cards and would market like an "independent". George Babikian, Arco's Senior Vice President for Marketing, heaped praise on the independent style of marketing and in May told a group of independent marketers he wanted to be "one of them."

Arco then began to cut its retail prices at direct and dealer operated stations which were in competition with independents. To make sure the price cuts were appropriately targeted, the company created more than 800 pricing zones and adopted a policy of holding the price at least three cents a gallon below the lowest competitor in a zone no matter how low the competitor went.

Arco's prices at competitive locations were so low they soon had lines at their stations and faced shortages of product. Rather than increase prices, the usual way in which demand is regulated, Arco bought spot market product at prices higher than its prevailing retail price, a maneuver which drove up the price of gasoline to all independents and deprived them of supply.

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[1] Testimony presented Feb. 22, 1983, to the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce.

More recently, Arco has gone into processing arrangements with independent refiners who can not make money under the market conditions Arco has created. These refiners are paid a fee for taking Arco's crude and giving it the product. The refiners used to be suppliers to the independent sector but are now out of the market. They have become totally dependent on Arco.

Arco is also trading other products, such as fuel oil, to get the gasoline it needs to support its below market clearing pricing. Thus, its fuel oil prices around the country are over those of other suppliers because it wants to discourage the purchase of fuel oil so that it is available to trade for gasoline.

Arco has also systematically declared war on its wholesalers, branded and nonbranded, as well as its retailers who market in competition with directly operated stations. Thus, in California it has held its wholesale price to nonbranded customers over its DTW to many retail units and where they have sold to wholesalers at competitive prices have held the wholesalers to contract minimums. In Pennsylvania, it has been selling on the street below its DTW to competing dealers.

In adopting this course of behavior, Arco has, in my opinion, violated virtually every antitrust law on the books. The violations include Robinson-Patman price discrimination against wholesalers and retailers, resale price maintenance enforced through threats to dealers, and subsidized below cost selling in zones drawn to target independent marketers.

The pattern of behavior taken as a whole is a classic "attempt to monopolize" case under Section 2 of the Sherman Act.

We also believe that there is a more serious Sherman Act case against Arco and the other majors operating in Alaska; they have agreed not to compete on the price of Alaskan crude.

Evidence of and opportunity for this conspiracy abounds. Begin with the way Arco ballyhooed its "new marketing" strategy. It said in press releases that it was cutting prices, but only at the retail level, and that it was going after the price conscious customers who did not use credit cards. That was a clear signal to the other majors that Arco would not cut crude prices and would limit its attempt to get market share to a fight with firms other than their North Slope partners who all market with credit cards.

In the face of Arco's onslaught in the product market, the price of crude has held. Rather than cut crude prices other major refiners have gone to processing arrangements and are keeping the product within their own system.

In plain English, we don't believe that the price of crude can stay above the price of product for months on end unless the major producing companies are working together to maintain that price. In a competitive market, the price of crude would have to drop.

Since it was discovered, the organization and operation of the Prudhoe Bay field, the TAPS pipeline, and the issue of lease sales in Alaska have been a matter of antitrust concern. For ten years, during the price control entitlements era we could all duck the issue because it didn't really matter. Controls were a substitute for antitrust enforcement and DOE and OHA acted as the industry's protector albeit imperfectly. If this Committee wants to maintain retail competition in this industry the North Slope antitrust question can no longer be deferred.

It is also increasingly clear that the only remedy in the long run to protect competitors who are downstream of crude producers operating in joint venture who are recipients of sweetheart deals and government tax subsidies is crude oil divestiture.

A divested Arco would have to compete by cutting the price of crude. It could not selectively cut the price of product to ruin independent competition.

When we have raised these issues in the past, Arco has defended itself by saying that it is "making money" across the board and that all it has done is build a better mousetrap which it is selling at bargain prices.

I'm afraid that Arco has a better mousetrap. But what it is using it for is to trap government money. Arco's exercise is being subsidized through the windfall profits tax in several very questionable ways. Arco has discovered that moving "costs" from crude production to transportation can save it more than 80¢ out of every dollar moved, by lowering windfall profits taxes and severance and royalty payments to the State of Alaska. Moreover by using another loophole in the tax laws it can treat most shipping charges on voyages from Valdez to other U.S. ports as "foreign source income."

By owning its own tanker fleet, Arco takes advantage of the Jones Act protection accorded U.S.-flag vessels. The Jones Act is especially important to this issue because more than one-half of all Jones Act shipping is in the Alaskan oil trade and Jones Act rates are at least three times world rates. There can be no justification for calling this foreign source income.

A measure of Arco's attitude toward the transfer price issue is found in its intense opposition to the sale of crude oil to Japan. Because a sale to the Japanese at Valdez would create a "real" transfer price it would significantly raise Arco's windfall profits tax payments. The irony of this situation is that even though the Japanese would pay more for the crude at Valdez than the companies now make on product, because of the way they do their tax calculations their net profit would be lower.

The remedy for the evasion of windfall profits tax through transfer price manipulation includes serious regulation of the TAPS line. TAPS rates are inflated deliberately to lower tax payments and that can be stopped by FERC. Opening the sale of crude at Valdez to foreign purchasers and preventing shipowners who have benefited from Jones Act protection from claiming that "foreign source income" is generated by their voyages would cut into other aspects of the problem.

If Arco takes issue with what I have said, I challenge them to make their tax returns public and show us all how they compute their tax liability.

The transfer price issue which is the principal focus of the hearing this morning is only one element of Arco's gaming of the windfall profits tax. As you will recall, the tax was based on the difference between the old controlled price and the wellhead price. The controlled price was in the hands of the Department of Energy which, as this subcommittee knows better than anyone, was less than zealous in doing its job.

Because IRS had to accept DOE's numbers on the controlled prices, getting around DOE regulation had tax consequences as well as control consequences.

Thus, when the controls were about to be lifted, companies went into a mad scramble to "decontrol" crude by committing to "tertiary recovery" projects. The main reason for this was not, as many of you suspected, to get more money out of the entitlements program, rather it was to lower windfall profits tax payments.

Arco was singularly successful in this exercise inasmuch as it wound up being owed more than $120,000,000 on the proposed final entitlements list despite its status as the country's most vertically integrated domestic crude producer.

I am sure Arco's lawyers figured in advance that the problem would fall between the DOE/IRS crack and be ignored, and to my knowledge they have been right.

Mr. Morrison has taken great public pride in Arco's refinery investment and Arco's investment in ships. We should not forget these investments were made with public money. Alaskan oil was given an exemption from payments to the entitlements program which over the program's life was worth more than $1 billion to Arco alone. It was justified on the grounds that Alaskan producers needed extra incentives to develop the reserve.

After the company had used the benefits to build its refineries it used them to defray the cost of paying its consultant Marc Rich more than $100 million for Nigerian crude. We know that is true because at the same time it was paying Rich Sohio, which had the same benefit, was forced to sell more than 20¢ a gallon below market to comply with price regulations. Sohio used the benefit to cut its price while Arco used it to pay an agent.

Our association has made the rounds on the Arco problem. We have been going to the Federal Trade Commission since last May. We have given the Commission a mountain of data. The staff has recommended action, but the management keeps wanting more data.

It seems that they don't want to run an antitrust case, they want to conduct an economic autopsy. We ask that you urge them to act quickly.

We have been to IRS which is aware of the tax problem but views the matter as an audit issue which may take years to resolve. Because of the amount of money involved, waiting years for an answer is bad public policy. From our standpoint waiting years is the equivalent of doing nothing because we won't be around when the relief comes. We ask you to put pressure on Treasury and IRS to act quickly.

We have urged a more stringent regulation of TAPS pipeline rates by FERC. Present rates produce $3.5 billion a year in revenue on a line that cost $9.4 billion to build. FERC has had the case for ten years and all parties know the present unregulated rates are too high. We ask you to press FERC to resolve the case and to show them how high pipeline rates can be used to make tax and royalty payments optional.

You may ask why Arco has not been sued in a private action. Our members have been told by counsel that relief in a private action is years away and that the first stage of litigation will cost $500,000. At the same time, Arco has told every independent it takes to lunch that it will ruin any company that sues it, that it has an array of lawyers and will spare no expense in fighting the case and that it will never again do business with any company party to litigation.

We must have your help if we are to survive. The help we seek is an end to tax subsidies to a competitor bent on destroying us and enforcement of the law by the FTC and FERC. We are not asking for subsidies, handouts or other forms of protection.

If these remedies fail we ask that you consider the next logical step, crude oil divestiture.

Attachments: (1) Babikian interview L.A. Times; (2) Oil Express article on sale to own stations at 3¢ below DTW; (3) L.A. Times article on Arco tax; and (4) Tax Ruling on Foreign Source Income.

[From the Los Angeles Times, June 17, 1982]

CUTS CREDIT TO WHOLESALERS—ARCO PLANS FOCUS ON RETAIL SALES

(By Karen Tummulty)

Atlantic Richfield Co.'s bold decision earlier this year to eliminate its credit cards is part of a much broader strategy that Arco officials acknowledge is likely to drive away some of the wholesale business that only two years ago accounted for more than half its gasoline sales.

Senior Vice President George H. Babikian, who is considered by many in the company to be the architect of Arco's marketing plan, said the Los Angeles-based oil company's focus in the future will be on boosting sales at its own retail gasoline stations.

"What we consider our life line and what we're basing our hope on for the decade of the 1980s are our own stations," Babikian said in an interview.

Only about 65 percent of the 7,000 service stations that carry Arco-branded gasoline nationwide are supplied directly by the company.

BUY FROM DISTRIBUTORS

The remainder of the stations receive their gasoline from Arco distributors, who buy it wholesale from Arco. Other wholesale customers include large industrial and commercial users, and distributors who sell the fuel under other brands.

The company plans to increase sales volumes in the retail outlets that it supplies by appealing to what it perceives to be a growing number of price-sensitive motorists, he said.

"We know what price marketing could do," he explained, "and we think we have the strength to be able to compete on a price basis."

But to do that, he said, the company must make dramatic cuts in its costs. The most visible cost-shaving move was its decision to drop credit cards last April 15, but Babikian said Arco also has "put some very tough requirements on the wholesale class of trade."

Thus, he acknowledged, a number of stations now carrying the Arco brand may be selling gasoline under another name.

He expressed little concern over the potential loss of wholesale business, and added, "It would be nice to get it 100 percent retail."

SEEKS EQUAL PROFITS

Tightening the demands on wholesale customers is not intended to drive them away, he explained, but to ensure that wholesale sales are as profitable as retail ones.

Arco declines to say how much of its present business is wholesale, but Babikian said that in 1980, retail business accounted for less than half of Arco's gasoline sales.

"The mix in our business was wrong," he said, explaining that relying on wholesale customers who can turn to a number of suppliers subjects Arco to "the vagaries of the wholesale market.

"You don't have any stability in that class of trade," he added.

Babikian declined to discuss the effect that Arco's decision to drop credit cards has had on sales, saying only, "There are no surprises in the results."

Arco had predicted at the time its announced its decision to discontinued retail credit that the business it would loss as a result, would be more than offset with new sales generated by its lower prices.

Industry sources agree that Arco has been able to set its wholesale prices lower than those of most competitors, although some have speculated that the company cannot maintain the cuts and soon will be forced to narrow the gap between its own and other companies' prices.

Among them are tighter credit terms, aimed at eventually putting gasoline wholesalers on the same cash-only basis as retail customers, and a tougher stance in requiring wholesale customers to live up to minumum purchase commitments in their contracts, Babikian said.

"This has been traumatic for many of our resellers," Babikian said. He predicted that many of Arco's wholesale customers will turn to other suppliers later this year as what is predicted to be a temporary tightness in gasoline supplies cases.

But others have suggested that Arco has become a sort of "super independent" and will continue to compete with independent oil companies, which generally sell gasoline at lower prices than those of major oil companies.

Arco also has instituted a "zone-pricing" system, in which its retail sellers in highly competitive areas receive gasoline from the company at lower prices. Some distributors have protested the policy.

However, Babikian said Arco's attorneys have assured it the practice is "completely legal."

Among other plans Arco is considering, Babikian said, is introducing on the West Coast a chain of tune-up centers it is test marketing in Boston and launching a massive advertising campaign aimed at making motorists aware of how much they are paying for such services as credit.

[Oil Express, Feb. 14, 1983]

FTC Asks Why Jobbers Pay 3.15 Cents More Than Dealers

Fact: Arco unbranded rack jobbers in Belmont, Pa. paid 3.15 cts/gal more for gasoline than dealers in April, 1982.

Fact: Some Arco Phoenix dealers paid nearly 13 cents/gal more in April, 1983 than others just miles away.

These are just two examples of seemingly topsy-turvy postings stemming from Arco's zone pricing practices. Those practices are being scrutinized by Federal Trade Commission investigators.

Arco has 222 pricing zones in Pennsylvania and 171 in California, say FTC memos. The zones are considered highly secret. Last April, Arco threatened to fire on the spot any employe who disclosed them.

The following chart, from FTC memos, show's Arco's DTW price and unbranded jobber price in six cities on April 23 or 24, 1982.

[Dollar amounts per gallon]

City	Arco zone	DTW price	Unbranded jobber
Stockon, Calif.	7085	$.9175	$.8830
Do	7420	.8760	
Do	7430	.8585	
Do	7435	.8670	
Do	7440	.8670	
Do	7445	.8480	
Do	7450	.8290	
Do	7455	.9050	
Do	7480	.9150	
Woodbury, N.J.	2201	.8505	.8480
Do	2202	.8490	
Do	2203	.8590	
Do	2205	.8190	
Do	2206	.8190	
Do	2207	.8490	
Culton, Calif.	9201	.8670	.8800
Do	9202	.8670	
Do	9203	.8670	
Do	9204	.9120	
Sacramento, Calif.	7055	.8860	.8830
Do	7065	.8570	
Do	7070	.8670	
Do	7075	.8480	
Phoenix, Ariz.	9702	.9465	.8845
Do	9703	.9540	

[Dollar amounts per gallon]

City	Arco zone	DTW price	Unbranded jobber
Do	9704	.9415	
Do	9706	.8490	
Do	9708	.8590	
Do	9711	.8690	
Do	9716	.9140	
Do	9721	.9765	
Belmont, Pa.	2101	.8245	.8465
Do	2102	.8245	
Do	2103	.8245	
Do	2104	.8340	
Do	2105	.8150	
Do	2106	.8150	
Do	2107	.8150	
Do	2108	.8340	

[From the Los Angeles Times, Dec. 9, 1982]

How Price Cutter Arco Saves on Windfall Tax

(By Karen Tumulty)

Atlantic Richfield Co., which has boosted sales in recent months by eliminating its credit cards and lowering its gasoline prices, has been aided in this strategy by charging its own refineries what some competitors say are artificially low prices for the oil it produces in Alaska.

While this reduces somewhat the profits the company can record for producing the oil, it takes a much larger bite from the tax Arco must pay on Prudhoe Bay oil output. Competitors and government officials contend that this amounts to an interpretation of the tax laws that may be subject to dispute.

Arco defends its pricing and denies suggestions that Alaskan tax advantages have made it possible for the company to charge lower gasoline prices. In essence, critics contend that what consumers are saving at Arco's gasoline pumps is coming partially out of government coffers.

"Even (if) Arco had no access to Alaskan North Slope crude (oil), our marketing program would be no different than it is today. We still would have pursued the 'no credit, low price' approach to gasoline marketing," Arco Senior Vice President George H. Babikian said in testimony before a House subcommittee in Washington last week.

'GOVERNMENT'S PAYING FOR IT'

But others say that tax savings are the crucial element that made it possible for Arco to maintain its profits while cutting its prices.

"The government's paying for it, absolutely no doubt about it," said an executive of a smaller independent oil company, who asked not to be identified by name.

The question centers on how Arco computes the taxable value of the oil it produces from the Prudhoe Bay field on Alaska's North Slope. Arco maintains that the accounting method it uses is the most accurate reflection of the value of its oil on the market. "We have had no difficulty with the Internal Revenue Service," Senior Vice President Martin Volandt added.

ALASKA STUDYING METHODS

IRS attorney Larry Cohn said the agency is studying certain portions of the complex windfall profits tax law. As it now stands, he said, some provisions that apply to Prudhoe Bay oil output are so ambiguous that oil companies have been allowed "to make their own interpretation of what they say."

"The statutes are not clear. That's the problem," Cohn said. "We are aware that there's a wide divergence."

State officials in Alaska also are scrutinizing the methods by which Arco is determining the amounts it pays in state taxes and royalties.

"The state is looking at the Arco situation and is considering expediting its legal prerogatives," said one Alaska state official, who would be interviewed only on the condition that he not be identified.

Arco estimates that it now processes 285,000 barrels of Prudhoe Bay crude oil a day—making that field's production the feedstock for almost half Arco's total output of gasoline and other petroleum products.

To understand the economics of selling and processing that oil, it is necessary to consider the effect of the windfall profits tax on Prudhoe Bay production and other oil that was discovered before federal price controls were gradually lifted to 1980 and 1981.

Although his name implies that the windfall profits tax is based on a company's earnings from decontrolled oil, the tax is not computed on "profits." Rather, it is figured on the sales price of the oil, minus the cost of transporting it from the well to the market. The result of this calculation is known as the oil's "removal value" or "end value."

PREVENTING HUGE PROFITS

The windfall profits tax is aimed at preventing oil companies from reaping a huge profit on oil-price gains made as a result of the lifting of oil price controls. Oil firms must pay 70 percent of the difference between the removal value and the government's estimates of what oil prices would be if controls had remained in effect on oil discovered before the price ceiling was lifted.

Thus, when an oil company raises its estimate of the removal value of "old" oil by $1 a barrel, it must pay 70 cents of that amount back to the government. And when it lowers its value on that oil by $1, its own revenue declines by only 30 cents, which the government's is lowered by 70 cents. The federal tax applies only when the removal value of the oil is above the government's base of about $16 a barrel, and it is adjusted to compensate for state taxes on the additional revenue.

The situation in Arco's case brings into question the tricky issue of what accountants call "transfer" pricing—that is, one arm of a company selling its output to another. When Arco provides oil for its own refineries, it must charge its refineries for the value of that oil and pay a 70 percent tax on what the government considers a "windfall" gain. When the oil is later sold as gasoline, Arco pay another set of taxes at lower corporate income rates.

What Arco has done, its competitors contend, is to estimate its Alaskan oil's removal value at the lowest rate possible. Because it "sells" almost all of the oil to its own refineries, it can charge lower prices for its gasoline as a result.

In September, the most recent month for which statistics are available, Arco estimated the removal value of its oil at $17.89 a barrel. By comparison, the other major Prudhoe Bay oil producers, Standard Oil Co. of Ohio and Exxon Corp., reported values of $20.25 and $19.91, respectively.

"Arco has been under the other two producers, Sohio and Exxon, by a considerable amount recently, said Geoffrey Haynes, deputy commissioner of Alaska's Department of Natural Resources. Figures compiled by the state indicate that the gap between the values reported by the three companies has widened steadily since June.

Arco began emphasizing low gasoline prices last April, when it eliminated its credit cards. Since then, it is estimated to have vaulted from the fifth largest seller of gasoline in California, its biggest market, to second largest. Its prices for self-serve, unleaded fuel now are estimated to be about 4 cents a gallon lower than the average for non-credit sales of the fuel in Los Angeles.

TRANSPORTATION COSTS AT ISSUE

Arco's Volandt said the difference between the various companies' Alaskan North Slope oil prices has grown, because Sohio and Exxon have raised their prices, despite a continued weakness in the oil market. Arco, on the other hand, has lowered its in recognition of a continued slump in demand, he said.

Vincent Wright, research chief in the petroleum revenues division of Alaska's Department of Revenues, said his Agency is taking a particularly close look at the transportation costs that Arco is deducting before determining the taxable value of its oil.

Although as much as 80% of Arco's Alaskan oil is processed at its West Coast refineries, the company is subtracting from its taxable sales the cost of transporting all that oil in the Gulf Coast—a long trip through the Panama Canal that would add an estimate $4 a barrel to the oil costs and apparently reduce by almost $3 a barrel taxes paid on that oil.

Officials at Exxon and Sohio said their companies subtract a closer approximation of the actual transportation costs of shipping the oil to its various destinations. They do not, they said, figure their taxes as though all the oil were being shipped to Gulf Coast markets. However, a much larger portion of those two companies' Alaskan oil sales is believed to made on the Gulf Coast.

"What (Arco is) doing, essentially, is backing out another transportation charge," Wright said.

However, Volandt countered, "The Alaskans have different views of the market than we do."

DISPARITIES WILL PERSIST

In making its estimate of taxable value of its oil. Arco is relying on a classic economic principle. Because the main market for Alaskan crude oil is on the Gulf Coast, Arco argues the logical way to figure the value of that oil—and thus, the taxes to be paid on it—would be based on the costs of selling oil there.

Industry sources say the disparities between the methods of computing taxes are not likely to be resolved soon. The IRS says it plans to issue a set of guidelines on deducting transportation costs but declined to speculate when those rules will be released.

On the trickier issue, that of determining the true value of oil that is sold within the company and not placed on the major market, those within the industry predict a longer battle.

"They'll never settle that one," one Arco competitor grumbled. "Hell, they'll be arguing that one in the year 2020. There's a range of reasonable values (for computing taxes) to look at."

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26 CFR 1.861.5: RENTALS AND ROYALTIES. (ALSO SECTIONS 862, 863; 1.862-1, 1.863-4.)

Income source; bareboat charter for U.S.-Alaska voyages.—Income received by a domestic corporate lessor leasing a vessel under a 1970 bareboat charter to an unrelated domestic ship operator who used it primarily for voyages between the U.S. and Alaska is income from sources within the U.S. to the extent allocable to periods the vessel is in a U.S. port and periods it is engaged in a voyage that begins and ends in a U.S. port and is traveling in U.S. territorial waters. Depreciation and interest payable on notes issued to purchase the vessel are allocable in the same manner.

REV. RUL. 75-483

Advice has been requested whether charter hire (rent) income received from the leasing of a vessel under the circumstances described below is income from sources within or without the United States. Advice has further been requested whether certain deductible expenses and other charges related to the vessel's operation and cost are allocable to income from sources within or without the United States.

M, a domestic corporation, purchased a vessel on March 15, 1970, and on March 16, 1970, leased it to *R*, an unrelated domestic ship operator, under a 20-year bareboat charter. The vessel was documented under the laws of the United States in *M*'s name by the Commandant, United States Coast Guard. *R* used the vessel primarily in transporting property from Alaska to various points in the United States. *R* was not prohibited from using the vessel in international trade. The vessel frequently traveled outside the territorial waters of the United States while engaged in coastwise trade. Under the terms of the charter *R* was responsible for operating, maintaining, repairing, and insuring the vessel, and for paying all costs, taxes or other charges associated with ownership, use, or operation of the vessel. *M* was the owner of the vessel for Federal income tax purposes and claimed deductions for interest expenses on notes issued to purchase the vessel and for depreciation of the vessel allocable to the charter income derived from *R*.

Section 861(a)(4) of the Internal Revenue Code of 1954 provides, in part, that rentals from property located in the United States shall be treated as income from sources within the United States.

Section 862(a) of the Code provides, in part, that rentals from property located without the United States shall be treated as income from sources without the United States.

Section 863(b) of the Code provides, that in the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

Section 1.861.-5 of the Income Tax Regulations provides, in part, that the income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether intangible or tangible, within the United States, is from sources within the United States.

Section 1.862-1(a)(4) of the regulations provides, in part, that the rentals from property located without the United States, or rentals for the use or property without the United States, shall be treated as income from sources without the United States.

Based upon the above provisions, the location of rental property both within and without the United States is determined by its actual physical presence within and without the United States. In the instant case, when the vessel traveled from one United States port to another United States port and when it was used in international trade it traveled outside the United States territorial waters, and, therefore, was located within the United States and without the United States at various times.

Accordingly, in the instant case, a charter hire paid to M by R for the charter of the vessel is, for Federal income tax purposes, income from sources within the United States to the extent allocable to (a) periods when the vessel is in a United States port between voyages, and (b) periods during which the vessel is engaged in a voyage that begins in a United States port and ends in a United States port and is traveling within the United States territorial waters. The charter hire allocable to periods when the vessel is traveling outside the United States territorial waters will be income from sources without the United States. Further, a proper ratable protion of allocation of the allowance for depreciation and the interest payable on the note will be allocable to income generated by the vessel that is income from sources within the United States. The remaining portion of the depreciation allowance and interest will be allocable to the income generated by the vessel that is from sources without the United States.

For taxable years ending after August 15, 1971, see section 861(e) of the Code that provides for an election to treat income from certain aircraft and vessels as income from sources within the United States with respect to leases entered into after August 15, 1971.

Mr. HANCE. Thank you.

Next, Ms. Nanay.

STATEMENT OF JULIA NANAY, VICE PRESIDENT, CHARTER OIL CO. PRESENTING STATEMENT OF WILLIAM F. KENNY III, ON BEHALF OF EMPIRE STATE PETROLEUM ASSOCIATION, INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION, NEW ENGLAND FUEL INSTITUTE, PENNSYLVANIA PETROLEUM ASSOCIATION, AND NORTHEAST COALITION FOR ENERGY EQUITY

Ms. NANAY. Good afternoon, I am Julia Nanay, vice president of the Charter Oil Co., of which Northeast Petroleum Industries is a wholly owned subsidiary. I am here instead of Mr. Bill Kenny, who couldn't come because of an urgent business problem, and he apologizes.

I present this statement on behalf of the Empire State Petroleum Association, the Independent Fuel Terminal Operators Association, the New England Fuel Institute, the Pennsylvania Petroleum Association, and the Northeast Coalition for Energy Equity.

All of these groups represent independent marketers of refined petroleum products on the east coast. I would like to submit my statement for the record, and summarize very briefly just some of the main points.

We are here to speak against one specific revenue-raising budget deficit-reducing measure, an oil import fee or an energy tax.

Earlier this year, the administration had considered a $5 per barrel contingency tax on oil as a way to raise revenues if certain economic conditions were not met in the future.

But as of yesterday, we understand that they have now abandoned this tax concept. However, there is still some talk in Congress about a $5 to $10 per barrel oil import fee on crude oil and refined petroleum products.

While this fee would raise some revenues, we are here to caution you that it would be terribly detrimental to the current economic recovery.

An import fee would raise the price of every barrel of oil consumed in the United States, and I think what is more important to understand is that the price of all domestic oil would rise to meet the cost of the marginal barrel which is the imported barrel.

Each dollar a barrel of an import fee would raise annual consumer petroleum costs by $5.5 billion annually and an increase of that magnitude would result in an increase of 1 percentage point in the inflation rate. Every time you read in the paper about any slight increase in the inflation rate, it is usually attributed to a small increase in fuel costs.

It is important to recognize that fuel costs drive up inflation. In a recent analysis which is dated March 1, 1983, the CBO stated that a permanent decline in oil prices would have a favorable longrun effect on the U.S. economy, higher growth and lower unemployment would significantly reduce the unified budget deficit, even though windfall profits tax revenues would be slightly lower.

However, if Congress enacts an oil import fee, it will deprive the American consumer and the Federal Government of these benefits; it will immediately and substantially increase consumers' petroleum costs, and will inhibit the economic recovery generated by lower oil prices.

These fees would bring only 35 cents of every dollar collected to the Treasury. The remaining 65 cents would be offset by, first, decreases in the collection of other taxes, resulting from the effect of higher petroleum prices on the economy, and, two, increased Federal outlays for petroleum purchases and for Federal programs which are indexed to the Consumer Price Index.

You have to understand that while an import fee might bring in additional revenues, it will reduce economic activity. Corporate and individual income taxes would be reduced with any drop in the GNP.

An import fee would affect every segment of the economy, not just energy. Increases in the cost of energy and petroleum-derived raw materials would affect all consumer's goods, and such increases would reverse the current economic growth in the auto and airline industries; they would drive up food prices. Farmers use large quantities of fertilizer, and fuel is needed to drive tractors and process harvested crops.

Then, again, the trade deficit would widen because petrochemicals, plastics and other export goods which are produced from petroleum would immediately become less competitive in the world market.

Because all industries have some energy cost component, the competitiveness of all U.S. products would be affected.

Thus, while the CBO estimates that a $5 per barrel fee would reduce imports by 200,000 to 300,000 barrels per day in the first year or year and a half, any possible balance of payments benefits due to reduced imports would be offset by reductions in exported products.

Finally, an import fee would not only hurt our ability to export products, but it would have a severe impact on some of our strongest trading partners. For the first time since 1973, OPEC members are not the principal suppliers of oil to the United States.

They have been replaced by Mexico, Canada and the United Kingdom.

It is these oil exporters, with the addition of Venezuela, our friend in the Caribbean, which would suffer most from the fee.

Clearly, there is very little rational, economic justification for an oil import fee. Moreover, oil users suffered through two severe energy crises in 1973 and in 1979.

It doesn't make sense for this Congress to punish them again.

Thank you.

[The prepared statement of Mr. Kenny follows:]

STATEMENT OF THE EMPIRE STATE PETROLEUM ASSOCIATION, INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION, NEW ENGLAND FUEL INSTITUTE, PENNSYLVANIA PETROLEUM ASSOCIATION, AND NORTHEAST COALITION FOR ENERGY EQUITY

My name is William F. Kenny, III. I am President of Meenan Oil Co., Inc., an independent marketer of home heating oil in New York, New Jersey, Pennsylvania and Connecticut. I am appearing today on behalf of the Empire State Petroleum Association ("ESPA"),[1] the Independent Fuel Terminal Operators Association ("IFTOA"),[2] the New England Fuel Institute ("NEFI"),[3] the Pennsylvania Petroleum Association ("PPA"),[4] and the Northeast Coalition for Energy Equity.[5] These trade associations represent independent marketers of refined petroleum products on the East Coast.

We wish to present testimony today in opposition to one specific proposal to increase revenues to meet the Budget targets for Fiscal Year 1984 through Fiscal Year 1984 through Fiscal Year 1986—an oil import fee or energy tax.

As the Committee knows, in January the President proposed a standby tax plan which would impose a $5 per barrel excise tax on domestic and imported oil under certain future conditions. In addition, during the past several months certain Members of Congress have proposed a $5-$10 per barrel import fee on crude oil and refined petroleum products as a means of reducing the federal budget deficit. However, there is a consensus that an oil import fee would be inflationary, restrict the economic recovery which is now beginning, and be inequitable and inefficient as a method of raising federal revenue. Accordingly, the members of our associations are strongly opposed to the imposition of any import fees and urge this Committee, for the reason set forth below, to reject such proposals.

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[1] ESPA represents over 500 independent retail home heating oil marketers and approximately 400 independent gasoline jobbers who serve every part of New York State. New York has a greater number of oil-heated homes and consumes more home heating oil than any other state.

[2] IFTOA is an association composed of 16 companies which operate deepwater oil terminals along the East Coast from Maine to Florida. None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies also market significant volumes of gasoline at wholesale and retail levels. Members handle nearly 50 percent of the non-utility residual fuel oil shipped to the East Coast, nearly 60 percent of the non-utility residual fuel oil shipped to New England, 25 percent of the No. 2 heating oil shipped to the East Coast, and more than 50 percent of the No. 2 heating oil shipped to New England.

[3] NEFI is an association of 1,164 independent retail and wholesale home heating oil distributors throughout the six New England states. The independent marketers serve 2.43 million retail home heating oil consumers and distribute 90 percent of the approximately 3.5 billion gallons of home heating oil sold in the New England area at the retail level and 70 percent of the gallonage sold at wholesale. Oil is used to heat 71 percent of all buildings in New England, both commercial and residential.

[4] PPA is the association of independent fuel oil and gasoline marketers in Pennsylvania. It represents over 500 petroleum marketers. Pennsylvania is the second largest home heating oil consuming state in the country.

[5] The Northeast Coalition is an ad hoc group representing fuel oil marketers throughout the Northeast. It seeks parity in prices for oil and gas in residential markets.

I. ADVERSE IMPACT

A. On energy prices

A fee applied to imported crude oil and products would raise the price of every barrel of oil consumed in the United States, because the market price of domestically-produced crude oil and domestically-refined products would rise with the price of imports. Each dollar of fee would raise annual consumer petroleum costs in the U.S. by about $5.5 billion per year.[6] Moreover, a $5 per barrel fee would result in an increase of nearly one percentage point in the inflation rate and a loss of $25-$30 billion in GNP.[7] (A $10 per barrel fee would, of course, have a proportionately greater impact).

B. On economic recovery

Since last February petroleum prices have dropped. These reductions have provided consumers with much needed relief; procurement costs for many Federal programs have also dropped; and consumer purchasing power is increasing without a corresponding increase in wages. The Congressional Budget Office, in a recent analysis of declining oil prices, stated that:

"[A] permanent decline in oil prices would have a favorable long-run effect on the U.S. economy. . . . Higher growth and lower unemployment would significantly reduce the unified budget deficit, even though windfall profit tax revenues would be slightly lower." [8]

However, if Congress enacts an oil import fee, it will deprive the American consumer and the Federal Government of these benefits, will immediately and substantially increase consumers' petroleum costs, and will inhibit the economic recovery generated by lower oil prices.

C. On commercial users and consumers

1. Consumer Goods and Food

Increases in the cost of energy and petroleum-derived raw materials would affect all consumer goods. Industries relying on crude oil and refined petroleum products, both as fuel and as raw material, would be most severely affected. In addition, any measure which would increase the price of gasoline and jet fuel would reverse the current economic growth in the automobile and airline industries.

An oil import fee would increase food prices sharply. Farmers use large quantities of fertilizer and other agri-chemicals made principally from petroleum; fuel is needed to drive tractors and to process harvested crops. Thus, the increased costs of growing, processing, and transporting agricultural products would be directly reflected in the prices paid by consumers.

2. Continued Conservation

The drop in petroleum prices has received concern that consumers will increase their use of oil, thereby reversing gains derived over the past several years from reduced demand. This concern is unfounded. Since the first quarter in 1981 when oil was decontrolled, prices have been steadily declining; U.S. refiner acquisition costs have dropped nearly $7 per barrel in the last two years, from a peak of about $36.50 per barrel in the first quarter of 1981[9] to approximately $29.62 per barrel in the first quarter of 1983.[10] At the same time there has been a corresponding decrease in U.S. demand.[11]

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[6] This cost estimate is based on a report of the Department of Energy ("DOE") that demand in 1982 was approximately 15.2 million barrels per day ("b/d"). U.S. Department of Energy, "Monthly Energy Review," DOE/EA/0035 (83/02) (February 1983).

[7] Petroleum Industry Research Foundation, Inc., "The Oil Import Fee Issue" (Apr. 19, 1982) at 6.

[8] Congressional Budget Office, "Economic and Budgetary Consequences of an Oil Price Decline—A Preliminary Analysis" (Mar. 1, 1983) at 2.

[9] U.S. Department of Energy, "Monthly Energy Review," DOE/EIA/0035 (83/02) (February 1983) at 82.

[10] U.S. Department of Energy, Energy Information Administration "Weekly Petroleum Status Report," DOE/EIA-0208 (83/26) (July 1, 1983) at 17.

[11] See Attachment A.

In short, conservation has continued despite the declining prices. Homeowners, commercial businesses, and industries have made investments over the past ten years to use fuel more efficiently; they have installed more fuel-efficient equipment and insulation and have improved industrial processes. The automobile industry is required by law to produce even more fuel-efficient cars. Homeowners and businessmen have geared their operations to saving fuel. They will continue to do so without further price increases mandated by government.

II. INEQUITABLE EFFECT

A. On regions

An oil import fee would affect several regions of the country and certain consumers more adversely than others. First, a fee would be felt more directly by the Northeast and portions of the Southeast because these regions rely more heavily on oil for heating, commercial, industrial and agricultural processing, power generation and transportation.

Second, a fee would discriminate against the nation's 14 million home heating oil consumers. At present the differences between residential heating oil and natural gas prices are significant. Although natural gas prices are increasing, on average home heating oil prices are still 21 percent higher than natural gas prices.[12] There is no energy or economic policy justification for discriminating against heating oil consumers. An import fee would only exacerbate an already difficult situation.

B. On trading partners.

Since 1977 the United States has steadily reduced its dependence on imported oil, and thus its vulnerability to supply disruptions.[13] For the first time since 1973, OPEC members are not the principal suppliers of oil to the United States.

Accordingly, an oil import fee would have only a minor impact on the OPEC nations, but a severe effect on such non-OPEC nations as Canada, Mexico, and the United Kingdom, from which the United States receives nearly half of its oil imports. These countries are among our nation's strongest trading partners.

III INEFFICIENT METHOD OF ACHIEVING GOALS

A. Raising revenues

The primary reason for imposing an oil import fee would be to raise revenue and reduce the federal budget deficit. However, an oil import fee is a very inefficient method of accomplishing this objective. Import fees and increases in windfall profit taxes collected as a result of rising petroleum costs would bring to the Treasury only about 35 cents of every dollar collected. The remaining 65 cents would be offset by (1) decreases in collection of other taxes resulting from the effect of higher petroleum prices on the economy, and (2) increased federal outlays for petroleum purchases and for welfare and unemployment programs.

B. Trade deficits

An import fee would create even greater trade deficits than we are experiencing now. First, petrochemicals, plastics and other export goods which are produced from petroleum would immediately become less competitive in the world market; moreover, they would be unable to compete fairly with imports in the domestic market. Second, because all industries have some energy cost component, the competitiveness of all U.S. products would be affected. Thus, any possible balance of payment benefits due to reduced petroleum imports would be offset by reductions in exported products.

C. National energy security

Although there are legitimate concerns about oil imports and their effect on national security, an import fee is among the least effective ways to deal with these concerns. The benefits of a fee in terms of import reductions would be small [14] and, as has been outlined above, the cost to the economy high. The Strategic Petroleum Reserve provides a far more effective and economic means of reducing the nation's vulnerability to oil imports.

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[12] See attachment B.

[13] See attachment C.

[14] The Congressional Budget Office estimates that a $5 fee would reduce imports by 200,000 to 300,000 b/d in the first year or year and a half. "Oil Import Tariffs: Alternative Scenarios and Their Effects," Staff Working Paper, The Congress of the United States Congressional Budget Office (April 1982) at 12.

IV. CONCLUSION

An import fee would constitute a major intervention by the government into the market. Historically such intervention results in distortions and inefficiencies, disrupting economic recovery. Moreover, as demonstrated above, a fee would not achieve its objectives. It would create unnecessary costs to the economy, and have an inequitable impact on many regions and consumers. In light of these serious adverse consequences, Congress should not impose an oil import fee.

Thank you very much.

[Attachment A]

Petroleum products supplied annually in the United States [1]

[In million barrels per day]

1980	17.056
1981	16.058
1982	15.201

[1] U.S. Department of Energy, "Monthly Energy Review," DOE/EIA/0035 (83/02) (February 1983) at 32.

NOTE.—Economists estimate that demand in 1983 will remain at 1982 levels—15.2 million b/d.

[Attachment B]

A COMPARISON OF THE MAY 1983 PRICES FOR NATURAL GAS AND NUMBER TWO OIL IN 27 U.S. CITIES

City	Per 100 therms natural gas [1]	Per gallon natural gas [2]	Per gallon no 2 oil [3]	Gas-oil price difference [4] (percent)
Chicago	$55.389	$0.77	$1.113	+44
Detroit	61.946	.86	1.098	+27
Los Angeles	64.232	.89	[5] 1.089	+22
New York	87.332	1.21	1.141	−1
Philadelphia	73.121	1.01	1.083	+7
Anchorage	25.720	.35	1.118	+219
Baltimore	69.120	.96	1.092	+14
Boston	84.418	1.17	1.129	−3
Cincinnati	60.930	.85	1.060	+25
Denver	60.117	.85	[5] 1.089	+31
Miami	60.050	.83	[5] 1.089	+31
Milwaukee	68.606	.95	1.006	+6
Portland	66.939	.93	.995	+7
St. Louis	67.577	.94	1.033	+10
San Diego	75.087	1.04	[5] 1.089	+5
Seattle	63.789	.88	1.153	+31
Washington, D.C.	78.591	1.09	1.144	+5
Atlanta	61.258	.85	1.063	+25
Buffalo	70.747	.98	1.135	+16
Cleveland	54.740	.76	1.090	+43
Dallas	55.503	.77	[5] 1.089	+41
Honolulu	152.440	2.12	[5] 1.089	−48
Houston	53.490	.74	[5] 1.089	+47
Kansas City	54.027	.75	[5] 1.089	+45
Minneapolis	64.513	.89	1.042	+17
Pittsburgh	57.196	.79	.985	+25
San Francisco	61.756	.85	[5] 1.089	+28
U.S. city average	64.774	.90	1.089	+21

[1] Source: U.S. Department of Labor, Bureau of Labor Statistics, "Consumer Prices: Energy and Food—May 1983."

[2] 100 Therms of natural gas equals approximately 72 gallons of No. 2 oil.

[3] Source: "Consumer Prices: Energy and Food—December 1982."

[4] The percentage by which the oil price exceeds (or is less than) the price of natural gas.

[5] BLS "U.S. City Average" price used in lieu of an actual price (no price for No. 2 oil for this city given in BLS statistics.)

[Attachment C]

OIL IMPORTS DEPENDENCY

Year	Total oil imports as a percent of oil supplies	Oil imports from OPEC as a percent of total imports
1977	48	70
1980	40	62
1981	37	55
1982	33	42

[1] U.S. Department of Energy, "Monthly Energy Review," DOE/EIA/0035 (83/02) (February 1983) at 32–33.
[2] Id. at 33 and 38.

Mr. **Hance**. Thank you very much.

Mr. Gibbons.

Mr. **Gibbons**. I will be brief.

First, I want to thank all of you for coming and waiting so long to make your statements. Your statements were good. I don't believe there should be new taxes, the recovery should take place and after we cut expenditures as much as possible, then we ought to take stock of where we are and what we are going to do.

I am not for a surtax or additional tax on those people who are already paying taxes. I frankly am for a broad-based consumption tax. That leads to my first question.

A couple of you have taken positions against an oil import fee and that is sensible. But are you against, at the appropriate time, after all the caveats have been met, any broad-based energy tax?

Ms. **Campbell**. The New England Council's position on energy taxes is that it is the wrong way to go.

Mr. **Gibbons**. What?

Ms. **Campbell**. It is the wrong way to go in taxation because consumers pay for any energy tax. But if push comes to shove, we would prefer an across-the-board Btu tax as opposed to oil import fee

Mr. **Gibbons**. That is what I hoped you would say.

Ms. **Nanay**. We would agree, also. We feel that, again, any energy tax would fuel inflation, that it is just the wrong way for economic recovery, but if you are going to have a tax, then it should be broad-based and not just hit the people that have already paid the high prices, namely the oil people.

Mr. **Gibbons**. Mr. Blum?

Mr. **Blum**. I have a somewhat different view of it. I think the problem with the broad-based energy tax is that it is very, very difficult to collect, because it is very hard to convert natural gas equivalents into coal equivalents, with different qualities and figure out who the customer is and at what level it ought to be paid.

You would lead the IRS to another tax they would have difficulty with. My view is if you want to tax energy, you have to do it at the consumer level and my instincts would be to do it at the gasoline pump rather than try to do it back at a producer level.

The confusion of trying to decide how to levy an equal tax on a utility that uses one grade of coal as opposed to one that uses another grade of coal—do you do it at the power plant or the consumer level?

The confusion would be enormous. I submit the best approach would be at the retail level, and at the retail level for specific products.

Mr. **Gibbons**. You made some interesting charges against owners and operators, particularly Arco, about the North Slope oil. Without pointing any fingers, I think it is something this Congress ought to follow up.

I have followed at a distance, legislative distance, the whole development of that. I realize it is a technical marvel, but I was surprised, I thought the Government was the only one that had such a terrible problem of price overruns.

I know there was a huge price overrun on that pipeline, something that the private businesses normally don't do.

Mr. **Blum**. It is more likely to do it when the overrun leads the inflated rate base.

Mr. **Gibbons**. I agree.

Mr. **Blum**. Now, we have the high rate base and now the high rates. So, if you take the rate base on the TAPS line, $9.4 billion, and figure the tariff on that pipeline which is generating $3 or $4 billion in revenue, it is a fair rate of return out of Alaska.

I think it is time for Congress to reconsider the tax treatment of that crude, because back in the control period, a lot of people felt it was reasonable to help these folks out as they built their pipeline, but now we have decontrol and very, very tough competition and the help you gave back then is turning up in a very different form and wreaking competitive havoc. And it is a potential source of real revenue for the committee.

Mr. **Gibbons**. Do any of you on the panel feel opposed to the idea of perhaps selling that oil to other than U.S. consumers?

Mr. **Blum**. We are very much in favor of allowing that oil to be exported because we think, among other things, it would set a real market price in Alaska. But it is also a rational thing because it would allow that oil to go to markets which are closer, allow us to save tremendous transportation costs, and in today's world would rationalize out trade with foreign countries, in particular Japan, in a way that would take considerable pressure off our trade relations.

Mr. **Gibbons**. Finally, in closing, I hope you folks in the grocery area don't feel I neglected you. I tried to signify in the testimony I was very interested in your product. I appreciate the very fine constructive testimony that you gave.

Mr. **Martin**. Thank you, Mr. Chairman. Thank you, Mr. Gibbons.

Ms. **Nanay**. Thank you.

Mr. **Hance**. I have several questions—wait, not so fast. I got a lot of good questions.

Mr. **Gibbons**. When this Texan comes at you, you better look out.

Mr. **Hance**. First of all, I noticed, Mr. Martin, your testimony and the others as far as the surcharge is concerned.

Yesterday—I don't know if you heard the testimony of the realtors or not—they talked about the possibility of addressing the deficits by having 3 percent below the COLA, below CPI, on your non-means-tested entitlement programs and then on your tax indexation to have 3 percent below the CPI when tax indexation goes into effect in 1985.

A combination of those is the tradeoff to lower the deficit. I would like to hear the panel's thoughts on that, starting with you, John.

Mr. **Martin**. I should state, Mr. Hance, that our organization has not addressed that particular issue. Of course, there is a practical problem with respect to the social security recipients involved in that question—and they are the largest group on the spending side.

That issue has been laid to rest by the recent social security amendments, we hope, at least for the next several years. I suspect if you got into that problem again, it would raise very difficult issues.

Of course, there is a great deal of appeal, it seems to me, philosophically, if you are going to do something to limit the indexing of some programs to also extend it across the board to other programs.

Just speaking for myself, and not the industry, there are some problems, of course, with indexing. There are problems with respect to the formula. I understand, for example, in the food industry that there are some difficulties in deciding exactly what a food basket of groceries should be. I think they take the shelf price of the groceries, but that does not take into account, for example, specials that the stores may be running from time to time, and it doesn't take into account things as coupons, things of that sort, that results in price reductions.

So, I just offer those general comments.

As I say, philosophically, there is some appeal if you do it in the tax area to do it also in the spending area. But I do again point out the problem of social security and, of course, you also have the means-tested programs that you would have to make some considerable concessions on, as you indicated.

Mr. **Hance**. Yes.

Mr. **Zegar**. As I indicated in my testimony, I think that in light of other possible taxes, such as surtax or freeze on estate taxes or whatever, this is the line of least resistance in effect.

What this indexing would do, by putting it at 3 percent, is it leaves intact existing programs at current spending levels, but controls future outlays and reduce the outyear budgets.

According to CBO estimates, indexing less 3 percent on the tax side, would raise about $57 billion in the next 4 years. If you apply the same formula to the COLA programs, it would raise another $60.2 billion for a $171 billion in savings over the next 4 years.

Also, I think that it is the least painful of all approaches, mainly because it is not something anyone has at this time. You are not taking anything away, but allows for indexing in case inflation exceeds 3 percent.

It is an attractive idea, and one that I think should be given consideration.

Mr. **Hance**. Mr. Smith?

Mr. **Smith**. Mr. Hance, we in the GMA have not studied this particular proposal in any detail. I think that one of the most attractive things about is it that it does try to deal with both the components of expenditures and revenue raising.

It is our belief that both of those components should be dealt with in the budget together, a long-range plan that will deal with the deficits as they are projected in the outyears.

So that while there are some elements of this that are certainly attractive, we would want to study it more thoroughly before we made judgments about it.

Ms. CAMPBELL. Congressman, I know the council has not dealt with this in depth, but I would ask for an opportunity to poll our membership and talk to my people and get back to you.

Mr. HANCE. We would be glad to hear from you.

[Nothing further was received.]

Mr. HANCE. Mr. Blum?

Mr. BLUM. My view would be that as a practical matter, it wouldn't work, the indexing proposal wouldn't work terribly well, because, as Congress gets into issue-by-issue spending and taxation, all across-the-board proposals begin to fall apart.

It is particularly true on the spending side. I have lived through, I can't guess, five or six Congressses where there have been across-the-board cuts proposed, and it never works.

Hiring freezes across the board are proposed, and they never work. So you really have to deal with specifics on expenditures and specifics on taxation.

Mr. HANCE. I think the reason they never worked, they never implement them? Isn't that right? Because you want your piece of the pie, and Fred wants his and Joe wants his.

Mr. BLUM. You are absolutely right, and then we all turn to our elected representatives and you all represent those interests and we get a result, and——

Mr. HANCE. Everyone takes care of their constituency.

Mr. BLUM. That is right. It is the process. It is a process going on for so many years.

Mr. HANCE. You better not try it, because it has not been done before.

Mr. BLUM. It has been tried, and, as I say, it has not worked terribly well. It is an attractive idea.

Mr. HANCE. It has been tried. Can you give me the year that we passed across-the-board cuts?

Mr. BLUM. We have across the board——

Mr. HANCE. It has been talked about.

Mr. BLUM. Personnel freezes.

Mr. HANCE. That has been talked about.

Mr. BLUM. Each incoming administration, to my memory, has frozen personnel levels. None of those levels have ever stuck. The number of Government employees has always increased within 1 year of the swearing in of the incumbent President.

President Carter froze personnel levels, President Reagan froze them, before him, President Ford froze them and President Nixon froze them.

It never worked once. Congress supposedly was backing it up, and in the real world, it all fell apart with the best of intentions. So I am not discouraging your efforts. I am just saying that my view is based on my own experience, that it is a very tough row to hoe, and I doubt it will be the short-run solution to the $200 billion deficit problem we are looking at right now.

Mr. **Hance**. Well, you were talking about Presidents freezing the number of employees, which is something that I didn't bring up. I think that is pretty obvious they talk rough about it and they do something else.

But I was talking about legislation that we passed into law, and that will be voted on, and if it became law, that is one thing. The problem we get into, a lot of times in budget resolutions, they will set targets and when it comes to passing the law to comply with the targets, that is where the coalition breaks down.

Ms. **Nanay**. Personally, I think it is an attractive proposal, but it would be hard to speak for all the groups I represent, because we have not taken a position on this.

Mr. **Hance**. Let me ask the three of you that testified last on the oil import fee.

If we have a fee, one of the things that you mentioned was that the price of domestic oil would go up. I think that is obvious.

At the same time, if we were trying to raise revenues, wouldn't that be a reason to do it?

Ms. **Nanay**. Yes, possibly, but as I pointed out in my testimony, the fact is that you raise only limited revenues from increased windfall profit taxes. As I said, out of every dollar you raise as a result of a fee, approximately only one-third goes to the U.S. Treasury because you reduce economic activity and there is a loss in GNP, which the CBO demonstrated would take place; you would reduce corporate taxes and individual income taxes, so any small benefit you might derive would be offset.

Mr. **Hance**. Let me ask you about home heating oil. I think that is a major concern of the people of your area, and you are using more foreign oil.

What would be the possibility of your supporting or even being neutral on a proposal that would have an oil import fee but exempt all oil going to a refinery designated for home heating purposes?

Ms. **Nanay**. Again, if we had to swallow an oil import fee, obviously we would want the heating oil exemption. The danger is that once you give one exemption, you will get other people coming in for theirs, and I don't see how you get away with just heating oil.

You have the farmers, you have a lot of groups out there that would be hurt as badly as heating oil consumers, the petrochemical industry, for example. The danger is you will open yourselves up to a lot of exemptions.

Mr. **Blum**. What I am afraid of is you would be restoring the power, influence, and glory of the Department of Energy, because we would immediately get an office that granted exceptions and tickets, special fuel for farmers, tickets for small refineries who were situated so they couldn't get domestic crude, and by the time we were finished with it, we would have a regulatory scheme to rival the one we just got rid of.

I hope you keep that in mind every time this proposal comes floating along. We have been here before. Every time we have had restrictions on imports in the past, we have had an office that granted exceptions and every time we have had that, we have had a regulatory morass and an absolute zoo of a bureaucracy to go with it.

Mr. **Hance**. One of your members told me, "Boy, don't pass an oil import fee, my profits would be cut in half." I think that that pretty well explains his position and yours.

Ms. **Campbell**. The New England Council represents manufacturers and other industries such as tourism which would be devastated by an oil import fee. Energy-intensive industries like paper companies in Maine would be hurt. So, I feel I have to indicate the council's concern about those interests.

Mr. **Hance**. I think the main thing was probably back to the first witness that testified on that question, is that you would not like it, it would be better than no exemption, and also, Mr. Blum's testimony is that you would not want to be creating another agency within the Department of Energy.

One last question, Mr. Blum, in reading your testimony, there was one statement that really shocked me and I see you say the Congress should reexamine the great cost of drilling for oil in Alaska.

Mr. **Blum**. That is right.

When you examine the oil on a per-barrel basis—I don't argue that total numbers are not very large—on a per-barrel basis is fully amortized, the cost of that oil is a tiny fraction of the cost of the oil being produced in new wells in Oklahoma, Texas and elsewhere.

Financial analysts who have looked at the companies that are——

Mr. **Hance**. Once they develop the field, what you are seeing if you take a new well that is being drilled in a proven area where there are proven reserves and don't look at any prior costs, that that well is in that classification.

Mr. **Blum**. No; I am talking about a fully amortized basis including the cost of original exploration and full cost of development.

Now, we have, and I will be glad to provide for the record, a financial analysis done by Drexel Burnham Lambere of Atlantic Richfield that breaks out the cost of Alaskan crude and it is $1.50 out of the ground.

So, that oil on a per-barrel basis is an awful lot cheaper than the Texas independents' oil coming out of the ground in a newly drilled well, even in an infield area in a proven field.

The cost of operation out there——

Mr. **Hance**. I would like to see your figures on that, because I know that the difference you pay for employees in Midland, Tex., versus what they make on the North Slope also is different.

We don't enclose our wells in Midland and Odessa when we drill. A lot of the employees like for us to, and air-condition them, but we never have done that. But in Alaska, they enclose the drilling rigs and so on.

You are saying for $1.50?

Mr. **Blum**. For $1.50 a barrel. The major reason for the cost differential is the wells in Alaska are prolific. The wells you drill in Midland and Odessa are producing what, 35 or 135 barrels a day as opposed to 5,000 a day.

The difference in productivity of the wells account for the difference in the per-barrel cost. Though the well may be expensive to put in initially, the per-barrel cost is much, much lower.

The same is true in offshore. Offshore United States, on a per-barrel basis is much lower cost oil than that domestic on-shore oil being drilled in your home district.

Mr. HANCE. Do you figure the dry holes?

Mr. BLUM. You get a lot of dry holes, too, and they get them. The track record on dry holes is worse in your territory than it is there and offshore.

At one point, in the Gulf of Mexico, which is an offshore area, there were actually more wells than there were holes drilled because there were completions at so many different levels.

So that the fact is still no matter how you look at it, the cost of producing oil in those areas which everyone talks about as being high cost is cheaper on a per-barrel basis than the oil independent producers in your home district are finding and are producing.

Mr. HANCE. Would you send me a copy of that?

Mr. BLUM. I would be delighted to do that.

Mr. HANCE. There are wells in my district that produce up to 2 barrels a day.

Mr. BLUM. I may have bought an interest in one of them, much to my chagrin.

Mr. HANCE. You got that one, and I got the dry hole.

Talking about IRS doing an audit on Arco, they are going through the audit, are they not?

Mr. BLUM. I don't know that. That is a matter between the company and the tax department. The windfall profit tax is one of the all-time nightmares administratively. The amount of paper generated on a per-well basis probably would be a foot or two high, because every interest holder and everybody involved in the well all have returns that get filed.

They didn't set the regulations up in a timely fashion. They are just beginning to dig into the audit, really.

It may be that this question that I have raised will be resolved on audit, but it is going to be 5 or 7 years before it is resolved. There are so many issues, so many questions, and IRS has so many bases to cover that that is cold comfort an audit is underway.

The fact is that the competitive damage is now and the revenue loss is now.

I have seen in dozens of other circumstances where there are major revenue losses and Treasury getting around to negotiating with the company involved, and then settling 20 cents or 50 cents on the dollar and there were enough ambiguities in what they did to make the case contestable and therefore settlement would be in order.

What I would like to see you do is set it out coldly and directly so there is no question and no competitive damage.

We won't be around to enjoy the benefits of the result of that audit otherwise.

Mr. HANCE. That is one thing that I understand—I understand why you are here, you represent your people, I understand that. The truth of the matter is this is something I know a little bit about, Arco started all this and they made wholesalers mad and made your people mad.

A bunch of them jumped me about that. Arco started that when they did away with the credit cards and dropped the price. They stuck it to the consumer in dropping the price and it set off a bidding war and gas war.

Other majors got into it, and the end result was that it is really cutting the margin of profit for your people. I understand that. They have had to remain competitive. I think it is more a question of they would like to keep it where it was, where everybody kept the price as it was and everybody made pretty good money.

Once the prices were cut, it set off a gas war that has carried all the way down. I am sure that hurt your people, right?

Mr. **Blum**. My people started a few gas wars in their time and have lived though them. What is going on here is substantially different. The money that Arco saved by eliminating credit cards was blown away in the first 10 days of the price cutting.

The price cutting took the price of retail gasoline in the California market below the market price for crude oil.

In other words, you as a customer could go to an Arco station in the Los Angeles basin and buy a gallon of gas, and when you multiplied what you paid at the pump less State tax, and added it back up, it didn't add to the cost of crude.

There were competing refineries paying more for a barrel of crude on a per gallon basis than Arco was charging a retail customer for a tankful of gas.

If you can do that and stay profitable, you are getting help somewhere, there is something fishy going on. It means there is no market price for crude or you are getting subsidized by someone.

As we began to dig into how this system worked, we found the windfall profit tax was giving them the ability to do that and in fact, that you take the money from the Treasury and the State of Alaska and take over the markets.

We are prepared to see margins go to zip if everyone starts out of the gate at something resembling a reasonable starting point. Namely, a market price for whatever the product is.

But if this committee permits Treasury to give one competitor a subsidy because they fail to rule properly on a tax loophole and puts $250 million in their pocket, and says go wipe these guys out, we can't survive.

That is not a consumer benefit, because it is restricted to people who buy at Arco stations. It is not a benefit across the board. Even your constituents in Texas don't benefit.

Mr. **Hance**. Your testimony said—one thing first—you said in the first 10 days their costs were wiped out. I don't think that was the premise. The whole thing evidently was to get more customers in.

Mr. **Blum**. Our people have done that, too, and you can't——

Mr. **Hance**. I wish you would do it more.

Mr. **Blum**. You can't increase volume and make up your losses when you are selling your product for less than you pay for it by getting more customers. The question we asked repeatedly is how can you sell gas for less than crude oil?

That means there is no profit in refining, no profit in marketing, and you come out profitable at the end. That means you are playing with your transfer price and it means you are probably playing with the tax system.

That is what we believe happened. We advise you to look at it.

Mr. **Hance**. Would you submit to me, Mr. Blum, a written statement about the amount people were paying for gasoline versus crude and give me the statistics on that?

Mr. **Blum**. Sure, be delighted to.

Mr. **Hance**. Let me tell you one other thing, I would like to see you get back to the good old days when we didn't have a Department of Energy, and you got into the gas wars. There used to be competition and it was fun, you could drive from station to station and——

Mr. **Blum**. We are delighted with the idea of gas wars and free and open competition, which is where we started and where we have done our best. It is true in Texas where a number of our members have had stations that have been hotly competitive, they complain and they are very bitter complainers when the margins go down.

What they can't abide is when one guy is playing with a deck that has some money put into it by someone else or a marked deck. We want the game fair and clear. We will play it as brutal and as bad as it gets.

Mr. **Hance**. You were talking about the $250 million, $240 million in your statement, would that have anything to do with the amount of the windfall profit tax? You know for every 16 percent, I believe it is, on a barrel of oil that comes out of Alaska, it drops.

Your windfall profit tax drops by almost 60 percent at that point. The margin price, the actual price you get is the bottom price. It is on the margin. The less taxes you mentioned that that company would have been paying, would that not have been due to the drop in price?

Mr. **Blum**. Well, we are talking about the transfer price, Mr. Hance. The problem is what is the transfer price? If there were a price that someone could wrap his hands around and say this is the price of this crude at which it came to market, this problem would not be here.

The fact of the matter is this company transfers the crude in a way in which there is never a price. So they are the ones who say we sold it to ourselves for, fill in the blank.

When they fill in the blank and finish the arithmetic, the price is so low they don't pay the tax. That is our problem. If you come and tell us there is——

Mr. **Hance**. You say they fill in the blank and no one ever checks?

Mr. **Blum**. That is damn near the way it is, because they set their own transportation rates and until you clarify whether you are talking about cost or whether it is the rate they set and charge themselves, until you clarify where the end market is, and tell IRS how to go calculate what a barrel of that crude is worth, there isn't going to be a way that that tax is collected.

Mr. **Hance**. Your organization always complains about DOE and IRS not being fair to your people, and they are too aggressive. But now you are saying that IRS probably is too nice to one of your competitors?

Mr. BLUM. In this case, it is probably not that they are too nice, but we are saying a complicated law has been put in place, there are minimum enforcement tools and the end result is a rather large and striking revenue loss, Treasury is not up to solving the problem in short order, and the amount of money is so large it is a life and death matter to us.

Normally this is not a concern. If one guy gets a break on the tax bill, who cares? But in this case, we care desperately because in those markets where Arco competes, that tax break is used to drive us out of business. It is limited to a select couple of markets. We think it is grossly unfair.

When the tax system is warped around that way, you just don't let it drive other people out of business. We think it is grossly unfair.

Mr. HANCE. Maybe the next time you come to me complaining about the IRS or DOE that we can talk about whether they were wrong, you know, selection of whether they are doing the right thing or being aggressive or not may be the case-by-case basis.

So we will look at that.

The other thing I was going to mention, you mentioned the cost of the pipeline.

Mr. BLUM. Yes.

Mr. HANCE. I think it is obvious, and Mr. Gibbons pointed out the cost of the pipeline, it has cost overruns. If you look at the way the pipeline was built, you know primarily for the caribou and everyone, if we had built the same pipeline when—in World War II, we built one from Texas to the east coast, if we had had the same standards they would probably be at Memphis, Tenn., still headed east.

Mr. BLUM. I understand what you are saying, but as you may recall, as I mentioned to Mr. Gibbons, the problem is not what it cost. It cost a lot of money. The problem is it seems to be coming back to the companies on about a 3-year return and by any standard is not a reasonable rate of return for a common carrier pipeline.

FERC is supposed to regulate that pipeline. There has been a case at FERC under way for the last 10 years. They still have not done anything like order the companies to set a rate. The likelihood is that you and I will be long gone from the Washington scene before FERC orders somebody to set a rate.

The fact is that the rate they set for themselves is a deduction against the wellhead price. That deduction comes 91 cents on the dollar out of the tax bill. In other words, every time you move a dollar away from the wellhead, you save 91 cents in windfall profit tax and Alaska royalty in revenue tax.

So that is a very substantial piece of business that Congress should be looking at.

Mr. HANCE. If you would write me a separate letter on the pipeline issue and give me those facts and bases for it, I would appreciate it.

[Additional information follows:]

[From Hearing before Senate Committee on Commerce, Science, and Transportation, Jan. 29, 1982, on S. 1626, a bill to improve the regulation of oil pipelines]

STATEMENT OF TEO SPENGLER, DEPUTY DIRECTOR OF STATE/FEDERAL RELATIONS, OFFICE OF THE GOVERNOR, STATE OF ALASKA, ACCOMPANIED BY ROBERT LOEFFLER, COUNSEL

Ms. Spengler. Good morning, Senator, Mr. Chairman, and members of the committee. I very much appreciate this opportunity to summarize the views of the State of Alaska on the question of oil pipeline regulation, an issue in which the State has a direct and vital interest. I am Teo Spengler, the deputy director of State/Federal relations in the Alaska Governor's office. Joining me today is Robert Loeffler, one of our Washington, D.C., counsels.

My comments today will deal only with regulation of the trans-Alaska pipeline system and its feeder lines. Alaska takes no position on the question of pipeline deregulation in the lower 49 States, but believes that whatever Congress may conclude about the desirability of continuing or discontinuing oil pipeline rate regulation as a general matter, such regulation should without question be continued for TAPS.

The State believes that TAPS is and will remain a natural monopoly, insulated from actual or potential competition. There is no network of competing pipelines or alternative modes of transportation to which deregulation advocates can point as forces tending to keep rates down. Nor is there any existing or potential competition from alternative modes of transporting North Slope oil to U.S. markets.

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[3] In the motion of the Justice Department to vacate the 1941 consent decree limiting the oil pipelines' return on equity, a central issue is the circumstances under which a dividend by an affiliated company constitutes a rebate. Statement of Points and Authorities in Support of Motion of United States of America to vacate the Final Judgment and for Other Relief at 6, *United States* v. *Atlantic Refining Co.*, Civil Action No. 14060 (D.D.C. 1981).

[4] Section 13(4) of the Interstate Commerce Act prohibits state regulations from discriminating against interstate or foreign commerce, and § 26(c) contains a similar provision for state taxes.

[5] Robinson-Patman Act, 15 U.S.C. §§ 13–136, 21a (1976).

[6] The statutory antitrust immunity of oil pipelines is limited to rate agreements between carriers which have been approved by the Commission. 49 U.S.C. § 5b (1976). The authority to enforce the Robinson-Patman Act as it applies to oil pipelines resides in DOE. 42 U.S.C. § 7155 (Supp. II 1978).

During the period between discovery of oil on the North Slope and the commitment to build TAPS, a number of other proposals were considered for the transport of North Slope oil. These included a possible trans-Canada pipeline route, icebreaking tankers, trucks, and railroads. All were rejected because none was as economical or generally as feasible as TAPS.

Nor do the owners of TAPS compete among themselves. North Slope production currently is matched to the capacity of the pipeline and is expected to continue to do so for many years. While production in the original field of Alaska's North Slope may begin to decline late in this decade, crude oil from other fields will be flowing into the pipeline. Oil from the Kuparak Field, for example, began to flow late in 1981. As long as the pipeline is operating at capacity, there is simply no incentive for any TAPS owner to cut its price or otherwise to compete, since it could not thereby increase its sales. A price cut would mean merely less revenue for the price cutter.

Even if production were to fall below the pipeline's capacity at some point in the future, it is less likely that price competition would ensue than that the pipeline owners would reduce capacity by decommissioning one or more pump stations, much as they increased capacity in the past by adding pump stations.

The industry-sponsored Barber report on TAPS discusses whether or not TAPS should be regulated and whether it is a monopoly. It argues that continued regulation is unnecessary to keep TAPS rates reasonable.

The State believes the Barber report is deeply flawed. First, the report cites the fact that the published tariffs of the TAPS owners differ as evidence of competitive forces. However, some owners have acknowledged, and as to others it has been shown in the TAPS litigation, that TAPS tariffs have always been set at the maximum allowed by a 40-year-old consent decree that restricts oil pipeline dividends and thus effectively limits rates.

TAPS rates vary only because the owners have differing capital structures and, therefore, differing limits under the consent decree. Moreover, as a consequence of cross-tendering much of the oil that moves through the pipeline does so at the composite rate—now about $5.85 a barrel.

Second, the Barber report cites potential competition from surface tankers and other as yet unbuilt pipelines as a constraint on TAPS rates. As I have already indicated, however, this is simply unrealistic.

Third, the Barber report dwells at length on the competitive nature of the market for Alaskan oil on the west and gulf coasts of the United States but does not discuss why that fact has any bearing on the TAPS rates.

As the report acknowledges, the market price of Alaskan oil is set by competitive forces at the oil's ultimate destination. Changes in TAPS rates do not, therefore, affect the market price. They affect only the wellhead price of the oil at Prudhoe Bay, which is determined by subtracting shipping costs, including TAPS tariffs, from the market price.

The centerpiece of the Barber report is the argument that in order to spur exploration and development of North Slope reserves so that enough crude is produced to fill the pipeline, the TAPS owners are interested in encouraging a reasonably high wellhead price and that that interest restrains TAPS tariffs.

Because the report completely ignores the fact that TAPS owners are also oil producers, however, its conclusion that the relationship between wellhead price and North Slope development restrains TAPS is simply wrong. To a producer who is also a pipeline owner, revenues from production and shipment are simply two parts in a single stream of income. All things being equal, an integrated company is thus largely indifferent between a dollar of wellhead revenue and a dollar of shipping revenue.

But all things are not equal. For one thing, TAPS faces no competition in the shipment of North Slope oil. There is considerable competition for the right to explore and develop North Slope reserves, which manifests itself in bidding for oil leases on State, Federal, and Alaska native lands. The lower the wellhead price, the lower the bids to an integrated company.

Therefore, the correct strategy is obvious: Maximize the profit, maximize the TAPS tariff, and so minimize the wellhead price. The total stream of revenues will be the same to the integrated company. But if the wellhead price is kept low, there will be lower taxes, less competition, and lower bids for leases, and thus higher net revenues in both the short run and the long run.

We must assume that rates would remain, if otherwise unconstrained, more or less at monopoly levels. This, of course, operates to the detriment of nonowner shippers. It also injures the State of Alaska by decreasing the wellhead price on which the State's royalty and tax revenues depend.

But that is not all. Excessive tax rates also decrease the income of the United States by reducing revenues from lease sales on the North Slope and Federal corporate income tax receipts. Under present law, a reduction of $1 on a TAPS tariff would increase Federal tax revenues by between 10 and 15 cents, over $60 million per year at present production levels. In addition, Federal royalties would be directly affected when Beaufort goes online in the early 1990's.

But the issue is not solely the health of the State and Federal treasuries. Of greater importance is the sensitivity of North Slope production and development to changes in the wellhead price, as evidenced by the recent cutback in development of the Kuparak Field because of reductions in projected oil prices. There are many potential oil-producing areas on the North Slope, and the development of each of them depends upon an adequate wellhead price. As the Department of Justice has recognized in the *TAPS* case, if TAPS rates exceed reasonable levels so that the wellhead price of North Slope crude oil is artificially deflated, incentives for exploration and production of new Alaskan crude oil will be reduced accordingly.

Mr. Chairman, to Alaska the rationale of rate regulation applies directly to TAPS, and the arguments advanced for deregulating other pipelines are inapplicable to this admitted monopoly.

This concludes my prepared remarks. Mr. Loeffler and I would be happy to respond to any questions.

Senator **Stevens**. Thank you. Some of my colleagues make the point that this dispute over TAPS is just a dispute between our State and the owners and it should not involve the Federal Government, and therefore we should be subject to the same general law that applies to all the United States. What is the State's answer to that?

Ms. **Spengler**. Although, in fact, the State is a party to the TAPS tariff litigation with the oil companies, this is an issue that affects not just the oil companies and the State. The Federal Government has revenues at stake, between 10 and 15 cents of each dollar that the TAPS tariff is reduced goes directly to the Federal Government in corporate income tax revenues.

Besides that, I think that there is a vital national interest in encouraging exploration and development on the North Slope. And that is something that this administration has been interested in.

Senator **Stevens**. How much money is escrowed already in that litigation?

Mr. **Loeffler**. Excuse me. I am a little short of voice today. But by the end of the year it will be in the vicinity of $2 billion.

Senator **Stevens**. Any indication at all when we can expect action by FERC on the issue, short of a settlement between the parties?

Mr. **Loeffler**. We hope that we will get a decision on phase I of the case in the next 6 months or so. But this past summer we moved for expedited consideration, and FERC turned us down. And they said when they get done with Williams, they will send a companion order down in TAPS. It is the only formal indication we have.

Senator **Stevens**. Then there is every expectation, even after the final decision by FERC, there would be continuing litigation, is there not, unless there is a settlement between the parties?

Mr. **Loeffler**. That is right. In fact, what we are expecting is a decision only in phase I of the case. And it is very likely that there could be a remand, another trial. It could go up to the Commission again, and then you go to court. And you could be looking at 5 to 10 years of continued litigation.

Senator **Stevens**. Thank you very much. I appreciate your testimony and your appearance here today. And we will obviously be concerned with the issue for some time.

[The statement follows:]

STATEMENT OF TEO SPENGLER, DEPUTY DIRECTOR, STATE/FEDERAL RELATIONS, OFFICE OF THE GOVERNOR, STATE OF ALASKA

Mr. Chairman and members of the subcommittee, I very much appreciate this opportunity to outline for you the views of the State of Alaska on the question of oil pipeline regulation, an issue in which the State has a direct and vital interest. I am Teo Spengler, the Deputy Director of State/Federal Relations in the Alaska Governor's office. Joining me today is Robert Loeffler, a partner in the Washington office of the law firm of Morrison & Foerster, who has represented the State on numerous matters, including the Alaska Gas Pipeline and aspects of the TAPS litigation.

My comments today will deal only with regulation of the Trans-Alaska Pipeline System—TAPS, as it is known—and its feeder lines. Alaska takes no position on the question of pipeline deregulation in the Lower 48 states, but believes that whatever Congress may conclude about the desirability of continuing or discontinuing oil pipeline rate regulation as a general matter, such regulation should without question be contined for TAPS. The State takes this position because TAPS is, and will remain, a natural monopoly. In the absence of regulation its tariffs will remain unreasonably high, thereby depriving Alaska and the United States not only of hundreds of millions of dollars each year but also of potentially hundreds of millions of barrels of oil.

Alaska's interest in TAPS rates is direct and vital. Alaska, with the United States, shares a crucial interest in encouraging development of the promising oil and gas potential in and near Alaska's North Slope. High TAPS transportation charges undermine the incentive for such development. Alaska, as the lessor of the Prudhoe Bay field, receives a royalty of one-eighth of the production, which, at its election, it may take in-kind. In recent years, Alaska has so elected and has sold its royalty oil to in-State and out-of-State buyers who must use the TAPS line to ship the oil to market. The price Alaska receives for the oil is the market price less transportation charges. High charges for transportation through TAPS thus reduce the wellhead price and lower Alaska's royalties. Alaska also levies severance taxes at the wellhead, and low wellhead prices reduce severance tax revenues. All in all, every dollar reduction in wellhead value means approximately 25 cents less revenue from royalties and serverance taxes to Alaska. For reasons explained later in my testimony, each dollar reduction in wellhead value also decreases federal revenues by between 10 and 15 cents.

Why should Congress single out TAPS? To begin with, TAPS and its feeder lines comprise the single largest oil pipeline system in the country. In fact, TAPS represents approximately half of the total U.S. investment in oil pipelines—more than 9 billion dollars—and earns approximately half of the revenues of all major U.S. oil pipelines. Moreover, it is the only means of transporting oil from Alaska's North Slope to U.S. markets. It is not merely another pipeline, and Congress can and should take specific account of TAPS' unique status as it considers pipeline regulatory policy.

In addition, TAPS has a combination of special characteristics that would make deregulation of its ratesetting processes very bad public policy. The historical bases for regulation of oil pipeline rates have direct applicability to TAPS, and the arguments advanced for deregulating pipelines in the Lower 48 states are inapplicable to it. You do not have to take the word of the State of Alaska on this point. The Departments of Justice and Energy, the Federal Energy Regulatory Commission (FERC), and the Office of Management and Budget all agree that TAPS should remain regulated even if pipelines in the lower 48 states are not.

Rate regulation was imposed on oil pipelines in 1906 because of a perception that those pipelines had substantial monopoly power which could be—and had been—used to achieve anticompetitive and other undesirable economic ends. Most directly, such monopoly power was seen as permitting pipeline owners to raise tariffs above competitive levels. Many current advocates of deregulation believe that oil pipelines no longer posses such monopoly power as a general matter, and that workable competition among pipelines or with competing modes of transportation may operate to keep pipeline rates at or near competitive levels in the absence of regulation. Without getting into the debate over whether this is true as a general matter, I want to emphasize that it is clearly not true as far as TAPS is concerned.

TAPS is a natural monopoly, insulated from actual or potential competition. There is no network of competing pipelines or alternative modes of transportation to which deregulation advocates can point as forces tending to keep rates down. TAPS is the only pipeline between Prudhow Bay and Alaska's southern coast, and will doubtless remain so. It cost $9 billion to construct in the mid-1970's, and, given the physical, financial, legal, and economic difficulties involved, it is clear that no competing pipeline will be built. If the need for additional capacity ever arose, it would be far cheaper to expand TAPS than to duplicate it.

The Administrative Law Judge in the *TAPS* rate case now pending before the Federal Energy Regulatory Commission determined, after hearings that fill 25,000 pages of transcript and generated 900 exhibits, that the possibility that another pipeline could be built to compete with TAPS is "remote." There is, Judge Kane found, "no substantial risk today of that possibility."[1] The difficulties being experienced with financing the proposed Alaska Natural Gas Pipeline System merely reinforce that conclusion.

Nor is there any existing or potential competition from alternative modes of transporting North Slope oil to U.S. markets. As Judge Kane's opinion in Phase I of the *TAPS* case pointed out, during the period between the discovery of oil on the North Slope and the commitment to build TAPS, a number of other proposals were considered for the transport of North Slope oil. These included a possible Trans-Canada pipeline route, ice-breaking tankers, trucks, and railroads. All were "promptly rejected" because none was "as economical or generally as feasible" as TAPS.[2] Recent confirmation of the infeasibility of nonpipeline competition with TAPS may be found in the case of the Coast Guard Icebreaker Polar Sea: two winters ago it become ice-bound in the vicinity of Kotzebue, off Alaska's Northwestern coast, and could not be extricated until the Spring.

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[1] Initial Decision Phase I Issues at 84, Trans-Alaska Pipeline System, Docket No. OR78-1 (F.E.R.C. Feb. 1, 1980) ("Initial Decision").

Thus, TAPS as a whole faces neither existing nor potential competition. In the words of Judge Kane, TAPS "enjoys a de facto if not a de jure monopoly position which, for economic feasibility reasons, it is practically certain to retain." [3] No one seriously contests this. Indeed, the Department of Energy reached the same conclusion in its May 1982 report on "Petroleum Pipeline Deregulation: A Competititive Analysis."

Nor do the owners of TAPS compete among themselves. North Slope production currently is matched to the capacity of the pipeline, and is expected to continue to do so for many years. While production in the original, Sadlerochit field of Alaska's North Slope may begin to decline late in this decade, crude oil from other fields will be flowing into the pipeline—oil from the Kuparak field, for example, began to flow late in 1981. One U.S. Geological Survey Report states that there is a 95 percent chance that an additional 7 billion barrels of oil will be discovered on or near the North Slope; if so, all of it will be shipped through TAPS.

As long as the pipeline is operating at capacity, there is simply no incentive for any TAPS owner to cut its price or otherwise to compete, since it could not thereby increase its sales. A price cut would merely mean less revenue for the price-cutter. Even if production were to fall below the pipeline's capacity at some point in the future, it is less likely that price competition would ensue than that the pipeline owners would reduce capacity by decommissioning one or more pump stations, much as they have increased capacity in the past by adding pump stations. The Department of Justice, in briefs filed in the *TAPS* case, has concurred in Alaska's position that the structure of TAP's ownership and various other factors make meaningful competition unlikely, even were production to fall below the pipeline's capacity. But the point is academic. The fact is that the pipeline will be operating at capacity well into the foreseeable future, so that at least for a considerable period of time there will be no competition at all among TAPS owners.

The industry-sponsored Mitchell Report does not address TAPS, and the TAPS owners therefore commissioned Richard J. Barber Associates, Inc. to prepare a separate report on "The Transportation of Alaskan North Slope Oil By Pipeline." The Barber Report, which was released last May, argues that continued regulation is unnecessary to keep TAPS rates reasonable because of existing competition among the owners of TAPS, potential competition from other means of transporting North Slope oil to market, and the alleged long-term interest of the owners in reasonable rates as a means of encouraging the development of North Slope reserves and thus keeping TAPS full. The State believes that the Barber Report is deeply flawed and wholly unpersuasive.

First, the Report cites the fact that the published tariffs of the TAPS owners differ as evidence of competitive forces. But some owners have acknowledged, and as to others it has been shown in the *TAPS* litigation, that TAPS tariffs have always been set at the maximum allowed by a 40-year-old consent decree that restricts oil pipeline dividends and thus effectively limits rates. TAPS rates vary only because the owners have differing debt/equity structures and therefore different limits under the consent decree. They would be still higher if the decree were not in place.[4] Moreover, as a consequence of cross-tendering much of the oil that moves through the pipeline does so at the composite rate—now about $5.85 per barrel.

In short, there is no price competition within TAPS. If there were, all of the TAPS owners would have reacted when Exxon, reduced its rates from $6.30 per barrel to $5.30 per barrel last December to meet the requirements of the consent decree. For six months, however, none of them did anything, and their respective shares of TAPS-transported oil did not change. In July British Petroleum reduced its rates, but did not claim that competitive forces played a role in its decision.

Second, the Barber Report cites potential competition from surface tankers and other, as yet unbuilt, pipelines as a constraint on TAPS rates. As I have already indicated, however, this is simply unrealistic. We would have thought that the conclusions of Judge Kane and the Department of Energy, the difficulties facing the Alaska Natural Gas Transportation System, and the fate of the icebreaker Polar Sea would lay to rest all speculation about alternatives to TAPS, including a stream of tankers moving in the Beaufort and Chukchi Seas.

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[2] Id.

[3] Id.

[4] Last fall the Department of Justice moved to vacate the decree, but a ruling on the motion has been postponed while the Department and the oil pipeline companies attempt to negotiate their differences.

Third, the Barber Report dwells at length upon the competitive nature of the market for Alaskan Oil on the West and Gulf Coasts of the United States, but does not discuss why that fact has any bearing on TAPS rates. As the Report acknowledges, the market price of Alaskan oil is set by competitive forces at the oil's ultimate destination. Changes in TAPS rates do not, therefore, affect the market price; they affect only the wellhead price of the oil at Prudhoe Bay, which is determined by substracting shipping costs (including TAPS tariffs) from the market price. The market price of Alaska's oil would thus restrain TAPS tariffs only if the TAPS owners were interested in maintaining the wellhead price and were willing to reduce TAPS tariffs to achieve this when the market price declines.

The centerpiece of the Report is in fact the argument that in order to spur exploration and development of North Slope reserves so that enough crude oil is produced to fill the pipeline, the TAPS owners are interested in encouraging a reasonably high wellhead price, and that this interest restrains TAPS tariffs. The State is pleased at the TAPS owners' acknowledgment that the wellhead price of North Slope oil has an effect on exploration and development. Because the Barber Report completely ignores the fact that the TAPS owners are also oil producers, however, its conclusion that the relationship between wellhead prices and North Slope development restrains TAPS tariffs is simply wrong.

To a producer who is also a pipeline owner, revenues from production and shipment are simply two parts of a single stream of income from Alaskan oil. All things being equal, an integrated company is thus largely indifferent between a dollar of wellhead revenue and a dollar of shipping revenue. But all things are not equal. For one thing, as I will explain in a moment recent changes in the Internal Revenue Code have caused TAPS income to be taxed at lower rates than income from the sale of Sadlerochit oil. In addition, while TAPS faces no competition in the shipment of North Slope oil, there is considerable competition for the right to explore and develop North Slope reserves, which manifests itself in bidding for oil leases on State, Federal, and Alaska Native lands. The lower the projected wellhead price, the lower the bids. To an integrated company, therefore, the "correct" strategy is obvious—maximize the TAPS tariff and so minimize wellhead price. The total stream of revenues will be the same to the integrated company, whatever it does. But if the wellhead price is kept low there will be lower taxes, less competition and lower bids for leases, and thus higher net revenues in both the short run and long run.

In sum, neither alleged but unproven competition nor unsupported assertions about the long-term interests of the TAPS owners can be counted upon to keep the rates of an unregulated TAPS at reasonable levels. We must assume that rates would remain, if otherwise unconstrained, more or less at monopoly levels. This, of course, operates to the detriment of non-owner shippers. It also injures the State of Alaska by increasing the portion of the market price of crude oil attributable to transportation and decreasing the remaining portion—that is, the wellhead price—on which the State's royalty and tax revenues depend.

But that is not all. Excessive TAPS rates also decrease the income of the United States by reducing revenues from lease sales on the North Slope and federal corporate income tax receipts. The Tax Equity and Fiscal Responsibility Act of 1982, passed by Congress last month, eliminated the de facto windfall profits tax exemption previously enjoyed by companies shipping oil through TAPS. As a result, profits on the production and sale of Sadlerochit crude are taxed at a maximum rate of 70 percent, compared to a maximum rate of 46 percent on pipeline profits. Under the new law, a reduction of one dollar in the TAPS tariff would thus increase Federal tax revenues by between 10 and 15 cents—over $60 million per year at present production levels.

The issue is not solely the health of the state and federal treasuries. Of greater importance is the sensitivity of North Slope production and development to changes in wellhead price, as evidenced by the recent cutback in development of the Kuparuk Field because of reductions in projected oil prices. There are many potential oil producing areas on the North Slope, and development of each of them depends upon an adequate wellhead price. Higher tariffs, with corresponding lower wellhead prices, make production at marginal fields uneconomic. Unlike lower 48 fields, consumer prices do not have to be raised to make additional oil North Slope production economic—a reasonable TAPS tariff will do the job. But in the absence of competition, TAPS tariffs will not be reasonable unless regulation is continued.

It is also important to the interests of the United States that high TAPS rates significantly misallocate resources and limit competition in the production of crude oil. As the Department of Justice has recognized in the *TAPS* case, if TAPS rates exceed reasonable levels so that the wellhead price of North Slope crude oil is artificially deflated, incenties for exploration and production of new Alaskan crude oil will be reduced accordingly. Even if the monopoly profits reaped by the TAPS owners are viewed as available for exploration and production, those companies receive a significant competitive advantage over their rivals in the industry who do not own a piece of TAPS, and competition in exploration and production is restricted. Either way, an important part of our national energy policy is undermined to the detriment of the public interest.

It is occasionally argued that the time and resources consumed by the regulatory process outweigh any possible benefits. The process has certainly been lengthy and expensive in the *TAPS* rate case, but that is attributable in part to the fact that FERC is addressing issues that have never before been properly resolved. It can also be explained, I regret to say, by FERC's failure to resolve the *TAPS* and *Williams* cases in a timely manner. Briefing and argument in Phase I of the *TAPS* case were completed over two years ago, but no decision has yet emerged from FERC. In May, the State of Alaska and the Department of Justice asked FERC to decide the case expeditiously, but were turned down. In the *Williams* case, which has now been pending for over a decade, a Federal judge has ordered FERC to issue a decision on the merits by mid-October. FERC's appeal of that order is pending.

In any event, once the *TAPS* and *Williams* cases are finally resolved and a set of ratemaking principles is established, such proceedings will be much shorter and far less expensive. And we must put the costs of this litigation into perspective. The total expended by all parties on the *TAPS* litigation to date has not exceeded the dollars taken in by TAPS in ten days, and the costs imposed on non-owner shippers by the monopoly prices that would prevail in the absence of regulation dwarf the costs of the *TAPS* case.

Mr. Chairman, to Alaska the issue is straight-forward and uncomplicated. The rationale for rate regulation applies directly to TAPS, and the arguments advanced for deregulating other pipelines are inapplicable to this admitted monopoly. Deregulating TAPS would only result in monopoly profits for the pipeline owners while undermining the incentive for competitive development of the nation's most promising energy reserves. There is no reason to include TAPS and its feeder lines in oil pipeline deregulation legislation and every reason to exclude them.

That concludes my prepared remarks. Mr. Maynard, Mr. Loeffler and I would be happy to respond to any questions.

PETROLEUM 4389

ATLANTIC RICHFIELD (ARC-43 5/8)
Redetermination A Welcome Development; Earnings Models; Third-Quarter Results

Joel D. Fischer
(212) 480-7162

November 10, 1982

Rating:	BUY (1)	Common-equivalent shares outstanding:	255 million
52-week range:	50-32	Dividend: $2.40 Yield:	5.5%
EPS 1981A	$6.66	P/E 1981A	6.6
1982E	$6.70	1982E	6.5
1983E	$7.50	1983E	5.8
Projected 5-year growth rate:	13.1%	Operating return on tangible assets:	17.0%
Market proxy expected return:	15.6%	Total debt/equity:	90.8%
Expected return:	16.2%	Return on equity:	19.8%
Market cycle beta:	1.58	Reinvestment rate:	13.3%

POINT OF VIEW

ARCO's recently increased claim upon Prudhoe Bay production provides a welcome boost to its near-term prospects, given the dour outlook for chemicals, hard minerals and metal fabricating. The company's already outstanding domestic production profile, as compared to other integrated majors, has been strengthened by the redetermination of equities in Prudhoe Bay reserves. Its improved crude sufficiency will also add to already formidable downstream strengths. We caution, however, that ARCO's vigorous exploration effort will continue to constrain near-term earnings gains; ARCO is looking beyond Prudhoe Bay and Kuparuk. We also caution that earnings will probably be down this quarter from a year ago because of sharply lower nonoperating income. We do not share the current anxiety that Kuparuk output, important to ARCO, may be made subject to windfall tax to protect the constitutionality of that levy. In any event, even if its present exemption were removed, wellhead value would have to rise by over $3 a barrel before Kuparuk output would be subject to windfall tax at the preferentially low rate for newly discovered oil.

We continue to recommend purchase of ARCO common as a core holding among the domestics. We believe that the stock remains cheap relative to market on a variety of criteria (relative P/E, discount from resource value, and expected return) and affords a superior hedge against upheaval in the Middle East. ARCO carries our highest rating, BUY (1).

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REDETERMINATION A WELCOME DEVELOPMENT

Effective October 1, ARCO's share of Prudhoe Bay production increased by 55.5 TB/D as a result of an interim agreement to realign the principal equities in the field. The increment of 55.5 TB/D includes 17 TB/D that will continue to accrue to ARCO so long as aggregate field output remains at 1.5 million B/D and 38.5 TB/D of "make-up oil" that will accrue to ARCO for 24 months. The make-up is compensation for past underlifting. ARCO's equity in Prudhoe Bay reserves has increased from 20.382% to 21.661%.

The redetermination agreement should permit ARCO to raise its domestic crude and NGL production by approximately 10% in 1983 despite natural decline of about 5% in non-North Slope output. The composition of 1983 output will be as follows:

Prudhoe Bay	335 TB/D
Kuparuk	60 TB/D
Lower-48	200 TB/D
Natural gas liquids	39 TB/D
	634 TB/D

ARCO's production profile would not suffer long from the termination of the make-up component at September 30, 1984. That decrement would be offset by a quantum jump in Kuparuk production.

The increase in ARCO's claim upon Prudhoe Bay output will provide a welcome lift to current-quarter and 1983 prospects. Absent that increase, current-quarter earnings could be down sharply from last year's $1.86 per share. The final quarter of 1981 had benefited from a pretax LIFO profit of $110 million and a pretax capital gain on Australian coal of $42 million. LIFO profit this quarter is estimated at $45 million and there will be no facsimile of the gain on coal. We also note that third-quarter 1982 earnings of $1.76 per share included a gain of $0.15 from a stock-for-debt swap; operating earnings were $1.61. No improvement in chemicals or minerals extraction has been sighted to date, and results in metal fabricating will probably worsen because of a hefty power increase for aluminum operations at Columbia Falls, Montana.

Higher prices for domestic crude are good news for production and unwelcome news for recently booming downstream operations. Effective October 20, ARCO raised its postings for Texas and New Mexico crudes by $1 a barrel. (Most other producers raised prices effective October 1.) Under ARCO's consistently-applied formula for pricing its North Slope supply, its sales prices for Prudhoe Bay and Kuparuk crude will also rise by $1 a barrel, effective October 20 or shortly thereafter. Higher wellhead prices mean higher production profits. They also mean increased crude-acquisition costs for refining. Margins on refining and marketing were already eroding from their August peak before this cost increase.

The improvement in ARCO's crude sufficiency from its Prudhoe increment will yield a quantum jump in production profits. It will also permit ARCO to substitute lower-cost Prudhoe crude for Lower-48 purchases, mitigating the effect upon refining of the general advance of $1 in crude costs. The seasonal upturn in natural gas demand, along with improving gas realizations, should also help production earnings.

We note below that a surge in worldwide exploration expense penalized third-quarter results. Exploration charges in the current quarter will

ATLANTIC RICHFIELD (Continued)

probably remain close to the third quarter's $265 million. Fortunately for current-quarter comparisons, exploration expense had soared to $282 million in the final quarter of 1981.

ESTIMATES

ARCO's prices for Prudhoe Bay and Kuparuk crude in September were $18.65 a barrel and $16.90 a barrel. We estimate the current prices at $19.65 and $17.90. Our current models of fully-taxed production earnings follow.

	Prudhoe Bay	Kuparuk
Wellhead price	$19.65	$17.90
Severance tax	2.95	1.43
Windfall tax	1.88	-
Ad valorem tax	0.25	0.25
Operating cost	0.50	2.00
Depreciation	0.75	3.00
State income tax	1.25	1.05
Federal income tax	5.55	4.68
Earnings per barrel	$ 6.52	$ 5.49

Ex downstream effects, the impact of redetermination upon current-quarter results will encompass incremental earnings on crude production, reimbursement of Sohio for past excess operating and maintenance costs, the cost of purchasing additional TAPS access, and incremental marine earnings. We estimate that by year-end ARCO will have reimbursed Sohio for three-quarters of $35 million of past operating and maintenance costs. ARCO's equity of 21.35% in TAPS is inadequate to accommodate its current access to 395 TB/D of North Slope crude; we estimate that ARCO is therefore purchasing 51 TB/D of throughput. We (boldly) allow for incremental pretax marine earnings at $0.50 per barrel on 55.5 TB/D.

	Pretax Contribution	Aftertax Contribution
	(Millions of dollars)	
Wellhead earnings	$68.0	$33.3
Cost reimbursement	(26.2)	(14.2)
TAPS access	(27.0)	(14.6)
Marine	2.6	1.4
	$17.4	$ 5.9

Fortunately, the drain of cost reimbursement is a one-time burden. We estimate the benefit to refining and marketing from increased crude-sufficiency at $3 per barrel or

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$15.3 million, pretax for the quarter; the aftertax value of the savings works out to $8.3 million. On combining upstream and downsteam effects, we estimate the net impact of redetermination in the current quarter at $14.2 million or nearly six cents per share.

Our estimates of integrated earnings for the current quarter and 1983 follow. Note that we posit a very slow economic recovery and that this year's estimated LIFO profits of $145 million will not recur in 1983.

Estimated Contribution By Segment
(Millions of dollars)

	Fourth Quarter 1982	1983
Exploration & production	$ 675	$2,800
Transportation	195	770
Refining & marketing	250	650
Total petroleum	$1,120	$4,220
Chemicals	(20)	70
Minerals	(70)	(140)
Metal fabricating	(35)	10
Operating profit	$ 995	$4,160
Interest	(105)	(450)
Other corporate items	(100)	(400)
Pretax income	$ 790	$3,310
Income taxes	330	1,400
Net income	$ 460	$1,910
EPS	$1.80	$7.50

We are shading our recent 1982 estimate of $6.75 per share to $6.70 and lowering our 1983 estimate from $7.60 to $7.50 as well.

THIRD-QUARTER RESULTS

ARCO reported $1.76 per share for the third quarter vs. $1.73 in 1981 and $1.62 for the second quarter. As anticipated, integrated petroleum operations were the mainstay of earning power. Cyclically depressed operations in chemicals, minerals extraction and metal fabricating were more deeply in the red than during the second quarter. A fillip of $0.15 per share from a stock-for-debt swap, which added 2.1 million new shares, provided the margin of improvement. Segment detail and other relevant financial information follow.

ATLANTIC RICHFIELD (Continued)

Contribution By Segment
(Millions of dollars)

	Three Months to Sept. 30		Nine Months to Sept. 30	
	1982	1981	1982	1981
Exploration & production	$ 585	$ 679	$1,916	$1,929
Transportation	192	166	561	515
Refining & marketing	277	223	550	301
Total petroleum	$1,054	$1,068	$3,027	$2,745
Chemicals	(25)	(17)	(39)	27
Minerals (a)	(74)	(77)	(200)	(156)
Metal fabricating	(31)	22	(35)	77
Operating profit	$ 924	$ 996	$2,753	$2,693
Interest	(103)	(95)	(307)	(246)
Other corporate items	(72)	(66)	(277)	(254)
Pretax income	$ 749	$ 835	$2,169	$2,193
Income taxes	302	401	927	992
Net income	$ 447	$ 434	$1,242	$1,201
EPS	$1.76	$1.73	$4.91	$4.80
Windfall tax	$ 194	$ .292	$ 650	$1,125
Exploration expense:				
U.S. oil & gas	$ 226	$ 165	$ 619	$ 531
Foreign oil & gas	$ 39	$ 14	$ 85	$ 42
ITC	$ 42	$ 42	$ 123	$ 108
Effective tax rate	40.4%	48.1%	42.7%	45.2%

(a) Includes coal

Production earnings were down 14% from 1981 despite the benefit to 1982 results from 61 TB/D of Kuparuk production. Currently more profitable Prudhoe Bay output was up 5 TB/D or nearly 2% but Lower-48 output declined 17 TB/D or 7.5%. The major causes of the earnings decline were an increase of 48% in worldwide exploration expense, from $179 million to $265 million, higher depreciation and depletion charges, and an advance from 11.6% to 15% (effective July 1, 1981) in the Alaskan state severance tax on Prudhoe Bay production. (The effective rate of severance tax on Kuparuk output is about 8%.)

The adverse impact of lower realizations for crude was substantially cushioned by a steep decline in windfall profits tax, from $292 million to $194 million. While ARCO's

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U.S. Liquids And Natural Gas

	Three Months to September 30					
	1982			1981		
Crude and NGL production (Thousands of barrels daily)						
Prudhoe Bay crude	280			275		
Kuparuk crude	61			-		
Other U.S. crude	209			226		
Natural gas liquids	39			39		
Total	589			540		
Realizations (Dollars per barrel)						
Prudhoe Bay crude	$18.72E	$1.55	$17.15E	$20.80	$3.47	$17.33
Kuparuk crude	16.90E	-	16.90E	-	-	-
Other U.S. crude	30.23	8.18	22.05	33.18	9.82	23.36
Total crude	$22.87	$3.83	$19.04	$26.39	$6.34	$20.05
Natural gas liquids	$20.47	-	$20.47	$22.37	-	$22.37
Natural gas sales						
MMCF/D	1,083			1,110		
$/MCF	$2.40			$1.86		

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wellhead price for Prudhoe Bay crude fell about $2.10 a barrel, the net-of-WPT value shrank by only $0.18. Windfall tax per barrel dropped from $3.47 to $1.55, pointing up the leverage attending a lower wellhead price and a higher base control price ($16.09 vs. $14.81). A decline of $2.95 a barrel in Lower-48 realizations translated into a net-of-WPT decrement of only $1.31.

Natural gas sales were down a modest 2% from 1981, in marked contrast to declines of 10% to 20% elsewhere in the industry. Like other producers, ARCO has benefited from expanded capacity but, much more important, it apparently enjoys a well above-average proportion of residential and commercial sales in its end-use markets. Realizations for gas were up strongly, from $1.86 per MCF to $2.40, facilitated by the buildup of production of higher-priced deep gas from the East Seven Sisters field in Duval County, Texas. Production began in May. Output of natural gas liquids was flat with 1981. Despite sharp recovery from depressed first-half levels, average realizations for NGL trailed 1981, $20.47 per barrel vs. $22.37.

Production in Indonesia averaged 38 TB/D vs. 32 TB/D.

A decline of 13% from the second-quarter contribution of production earnings also commands attention. An increase of nearly 23% in exploration charges was, once again, a major culprit. Other negatives included declines of 4 TB/D and 8 TB/D in Kuparuk and Lower-48 output and small reductions in average realizations for both Alaskan and Lower-48 crude. A seasonal decline of 5% in natural gas sales was more than offset by an increase of 13% in average realization, up from $2.12 per MCF to $2.40. Realizations for natural gas liquids snapped back strongly, from $15.62 a barrel to $20.47.

ATLANTIC RICHFIELD (Continued)

Increased pipeline throughput in Alaska was the major source of an advance of 16% in transportation earnings, from $166 million to $192 million. Tanker movements were larger too. Transportation had contributed $186 million in the second quarter.

The contribution of refining and marketing expanded from $223 million to $277 million or by 24%. In the second quarter, it had been $153 million. Third-quarter results included a pretax LIFO profit of $46 million vs. one of $30 million a year ago and $45 million in the second quarter. Exclusive of LIFO profit, downstream results in the third quarter were the best in ARCO's history. Operating profits peaked in August.

ARCO has made effective use of its highly efficient refineries and its advantageous access to economical crude streams, including its own low-cost North Slope output and purchased Mayan supply from Mexico. It ran its refineries above rated capacity (647 TB/D) during the third quarter and aggressively went after market share with a low-price strategy. Crude runs averaged 672 TB/D vs. 627 TB/D in 1981 and 624 TB/D in the second quarter. Accompanying runs of unfinished stock were 18 TB/D vs. 51 TB/D in 1981 and 49 TB/D in the second quarter. Product sales averaged 676 TB/D vs. 626 TB/D in 1981 and 663 TB/D in the second quarter.

As noted, results in chemicals, minerals extraction and metal fabricating were disastrous. ARCO has done an impressive job in bringing down its breakeven price for copper from $1.25 per pound to an estimated $0.95. Unfortunately, its average sales price for copper was down 19 cents a pound from 1981 during the third quarter, from 78 cents to 59 cents. With the aluminum markets weak and growing weaker, Anaconda Aluminum's realization for ingot slid from 75 cents a pound to 50 cents; export demand was dead.

Coal was the one bright feature of minerals operations, with shipments up to 4.9 million tons (as in the second quarter) vs. 4.0 million tons in 1981. Output from the Black Thunder mine in Wyoming reached 4.3 million tons in the third quarter vs. 3.7 million tons a year ago.

A decline of 7.7 percentage points in ARCO's effective tax rate reflected a drop in the Alaskan state income tax rate from 11% to 9.4% and the inclusion in pretax income of the tax-free gain of $38 million from the stock-for-debt swap.

Our last Abstract on ARCO was dated August 11, 1982.

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Mr. **Hance**. If you write me those letters and if I think you are right, I will help you, but I guess what galls me a lot of times, we have business people that come up and it is like going to maybe the chamber of commerce banquet, the first thing they do is read a resolution, is ask you to balance the budget and cut food stamps and next, they want a resolution for a new highway or industrial development bonds extended.

Mr. **Blum**. I will be delighted to back it up. The reason my testimony was abbreviated was I appreciated the time limits of the committee, and I might say that there is another committee of Congress which has gone into it rather extensively, oversight and investigations of the Commerce Committee, there is an extensive record on this issue, which I believe we can easily call to your attention and I will do my best to give you those facts and figures you have asked for.

I appreciate your kind offer of help when we do get there.

Mr. **Hance**. I look forward to receiving them.

One thing that one of the other members pointed out, I want to ask unanimous consent to let Arco submit a rebuttal for the record, since you have accused them of cheating on their taxes.

Thank you very much, we appreciate your testimony.

And we will call the next panel.

[The following was subsequently received:]

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William C. Bennett, Jr.
Director
Government and Tax Affairs

COMMITTEE ON
RECEIVED
AUG 3 - 1983
WAYS AND MEANS

August 1, 1983

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The Committee on Ways and Means held hearings on July 20 and 21, 1983 to receive testimony on proposals for revenue increases. During those hearings a representative of the independent gasoline marketers, Mr. Jack Blum, testified making some unfounded allegations concerning Atlantic Richfield's method of calculating its windfall profit tax on Alaska North Slope production. Attached is a copy of Atlantic Richfield's written statement rebutting the allegations raised by Mr. Blum. This statement was timely filed with the Committee on Friday, July 29.

I am also taking the liberty of enclosing a one-page response setting forth the key points contained in the longer written statement.

If you have any further questions concerning this matter, I will be pleased to meet with you or members of your staff in order to resolve them.

Sincerely,

William C. Bennett, Jr.

WCB:tzp
Attachments

ATLANTIC RICHFIELD COMPANY (ARCO)

RESPONSE TO
ALLEGATIONS OF CERTAIN INDEPENDENT GASOLINE MARKETERS

ALLEGATION: ARCO is being mischievious, or taking advantage of loopholes, when it uses Gulf Coast crude prices in its Alaska North Slope (ANS) windfall profit tax (WPT) methodology since much of its oil goes to the West Coast. The result is an underpayment of taxes and a source of revenue to ARCO enabling it to be a low pricer to the detriment of other refiners and marketers.

ANSWER:

1. **ARCO'S WPT PAYMENTS FOR BOTH WEST COAST AND GULF COAST CRUDE OIL DELIVERIES ARE BASED ON VALUES WHICH EQUATE TO PUBLICLY POSTED PRICES OF CRUDES PRODUCED AT SUCH DESTINATIONS (ADJUSTED FOR QUALITY).**

   Based upon its method for the wellhead valuation of ANS crude oil, ARCO's value for its ANS crude landed on the West Coast has consistently approximated the prices posted by other West Coast refiners of equivalent quality crudes produced in California. In other words, the methodology consistently applied by ARCO for valuing all its ANS crude oil results in a reported value for the portion of such crude actually taken to California which approximates the value that would have been arrived at if our valuation methodology for that portion had been based directly on the use of California posted prices.

2. **ARCO'S GASOLINE PRICES HAVE BEEN DETERMINED BY COMPETITIVE CONDITIONS.**

   ARCO, with only 5% of the national gasoline market, is not engaged in any program to eliminate competitors and raise prices. Its lack of leverage, and the ease of market entry by others, make such an allegation preposterous. What ARCO is doing is defending its niche in the market as a no-frills quality-price marketer by meeting the challenges, on a localized basis, of all competitors.

3. **WHAT MANY JOBBERS ARE SEEKING IS, SIMPLY, HIGHER GASOLINE PRICES, ANY WAY THEY CAN GET THEM.**

   ARCO has become a symbol of efficient, consumer-oriented marketing in a marketplace characterized by surplus gasoline refining and marketing capacity. This surplus results in competitive prices which are beneficial to consumers. Some marketers seek to be sheltered from this competition by trying to intimidate competitive marketers into raising their prices. ARCO is a target selected for that intimidation effort.

Attached is a more detailed response showing the allegation to be specious and totally without merit.

STATEMENT OF ATLANTIC RICHFIELD CO.

On July 21, 1983, in testimony before the Committee on Ways and Means ostensibly concerning possible federal revenue raising measures, Jack Blum again made unsupported allegations concerning Atlantic Richfield Company business practices. Certain independent gasoline marketers, perceiving themselves to be disadvantaged by the competitive realities of retail gasoline marketing, apparently have chosen Atlantic Richfield as their target. We appreciate this opportunity to comment on the allegations lodged against us.

Mr. Blum charges that Atlantic Richfield, as a major Alaska North Slope (ANS) oil producer, unfairly manipulates the pricing and shipping of its ANS crude in order to reduce grossly its windfall profit tax liability. Moreover, he claims such manipulation in turn allows Atlantic Richfield to compete successfully but unfairly by passing its apparent tax savings (or subsidy) on to its customers in the form of low gasoline pump prices.

Atlantic Richfield believes it has been and continues to be in compliance with the Crude Oil Windfall Profit Tax Act (WPT) as legislated by Congress. We do recognize that a substantial shakeout is underway in retail gasoline marketing. We candidly admit that we intend to remain competitive to succeed in that market, based on our refining and marketing efficiencies and innovations. It seems to us obvious that our compliance with the provisions of the WPT does not give us any unfair market advantage. In any case, no crude oil producer would deliberately underpay its WPT liability and pass such "savings" on to consumers, knowing that it is under audit by the Internal Revenue Service (IRS) and that assessed taxes could not be later recouped in the marketplace.

We believe that the IRS audit, begun in late 1981, will confirm our compliance with the WPT. We continue to believe that the audit should proceed unimpeded, conducted by those expert in the complex statutory and regulatory details of the WPT. Below, we set forth a qualitative description of our ANS crude pricing, make some further comment on the Blum testimony of July 21, and briefly describe gasoline market realities.

ANS pricing /WPT payment

Any consideration of WPT liability on ANS crude oil must begin with the value of crude oil at the wellhead. Atlantic Richfield follows common sense, standard industry practice and positions taken by the IRS with respect to federal income tax in valuing ANS crude oil at the wellhead. Specifically, we adhere to the principle that at any given point in time there is one, and only one, value at the wellhead for crude oil produced by any given reservoir.

The Windfall Profit Tax Act provides rules regarding how a wellhead price is to be determined. In those instances where a producer sells crude oil at the wellhead to an unrelated party, the price of the oil, for purposes of WPT calculation, is the actual selling price agred to by buyer and seller. Most producers of North Slope oil, including Atlantic Richfield, do not sell the crude oil they produce to unrelated parties at the wellhead. In the absence of such sales, the law explicitly requires these producers to determine a "constructive sales price" to calculate their WPT liability. Under the facts and circumstances pertaining to ANS crude oil, the "constructive sales price" should equal the price at which the oil would be sold in its representative market to an unrelated party, less the value of transporting that oil from the wellhead to that market.

If the price at which a particular crude oil could be sold in its representative market were, hypothetically, $30 a barrel and the value of transporting that crude from the wellhead to that market were $10 a barrel, the "constructive sales price" of the crude—its value at the wellhead—would be $20 a barrel. If the oil is not sold at the wellhead by its producer to a party unrelated to that producer, the law stipulates this "constructive sales price" must be used for tax purposes.

In order to calculate the WPT liability on its ANS crude oil production, Atlantic Richfield, therefore, must derive a "constructive sales price," or single wellhead value, from the representative market for that crude oil. To determine the "constructive sales price," the Company must first establish the representative market for its ANS production.

We find that market realities for ANS crude oil production dictate that the Gulf Coast refining center is its actual representative market. West Coast and Alaskan crude oil production currently exceeds the demand of West Coast refineries. The refining center on the Gulf Coast is crude deficient, so it becomes the logical alternative market for the Western crude oil that is suplus to West Coast demand.

Almost half of all ANS crude is shipped to the Gulf Coast, the producing and refining center of the U.S., where it is refined along with some two million barrels per day of West Texas Sour and other closely comparable crudes. By determining the value of our ANS crude with reference to Gulf Coast prices, we are most clearly reflecting the prices received in literally thousands of arms-length transactions between unrelated parties involving crudes comparable to ANS crude oil and, in some cases, ANS crude oil itself.

Having identified the Gulf Coast as the representative market, we then ascertain the price in that market in order to calculate a "constructive sales price." To return to the hypothetical example, if the competitive price for crude oil of quality comparable to ANS crude is $30 a barrel in the Gulf, and the value of transporting ANS crude from the wellhead to the Gulf is $10 a barrel, the "constructive sales price" of ANS crude oil at the wellhead is $20 a barrel.

Of course, ANS crude may have different landed values in different geographical locations, because of the different value of transporting it to those locations. In the hypothetical example, with ANS crude having a $20 value at the wellhead, its delivered price on the West Coast would be $27 assuming a transportation value of $7, while its delivered price in the Gulf Coast might be $30 assuming an Alaska to Gulf Coast Transportation value of $10.

Based upon this method for the wellhead valuation of ANS crude oil, Atlantic Richfield's value for its ANS crude landed on the West Coast has consistently approximated the prices posted by other West Coast refiners of equivalent quality crudes produced in California. In other words, the methodology consistently applied by Atlantic Richfield for valuing all its ANS crude oil results in a reported value for the portion of such crude actually taken to California which approximates the value that would have been arrived at if our valuation methodology for that portion had been based directly on the use of California posted prices.

FURTHER COMMENT

Atlantic Richfield strongly rejects the suggestion that Congress should somehow redefine legislatively the method used to calculate the WPT on ANS crude oil production, specifically its "removal price." As described above, the existing statute provides for valuation of all domestically produced crude oil for tax purposes, consistent with complex and constantly changing circumstances of time and location. Valuation issues cannot be resolved equitably by a fixed, inflexible formula written into law or regulation.

The statutory provisions for determining "removal price" are consistent with Congress' intent to impose a tax on the "windfall" attributable to the increase in the wellhead value of crude oil resulting from the decontrol of domestic crude oil prices. As such, the tax is not imposed on the relative profitability of any given reservoir of crude oil; it is instead an excise tax, levied on wellhead values, regardless of profitability. Any apparent "tax savings" by Atlantic Richfield under the WPT for ANS production reflects imagination on the part of the beholder, not appreciation of reality.

Atlantic Richfield also takes issue with the insinuation that the IRS is ill-equipped to evaluate questions of WPT liability. At the least, the assertion is disingenuous, since it presumes improper calculations on the taxpayer's part. More importantly, the IRS audit process is exactly the proper means by which to resolve any questions concerning WPT calculations for ANS or any other domestic crude oil production. The IRS has addressed wellhead value issues, in a variety of contexts, in the past; the IRS has access to, and the means to execute an examination of, detailed industry-wide data necessary to make an informed judgment, and the IRS has authority to correct any improprieties. The IRS audit is not only the proper means to resolve any question as to WPT treatment of ANS crude oil; it is the effective means to do so.

(We should note the interesting fact that while the IRS audit of Atlantic Richfield's and other major producers' WPT payments began in late 1981 as a matter of course, allegations as to our WPT improprieties occurred only after our retail marketing program, in particular the elimination of our credit card, achieved some success in 1982.)

With respect to the assertions made in the July 21 testimony concerning the transportation of ANS crude oil, the Trans Alaska Pipeline System (TAPS) is a common carrier subject to the Interstate Commerce Act. By law, TAPS tariffs are regulated by the Federal Energy Regulatory Commission. Furthermore, all of the major ANS oil producers, Atlantic Richfield, Exxon and Sohio, either own or charter U.S. flag tankers to transport their crude oil production to lower 48 refining centers at rates set by the market for Jones Act tankers.

GASOLINE MARKET REALITIES

Atlantic Richfield Company, like every other United States marketer of petroleum products, has had to confront the reality that total petroleum demand has been shrinking since 1978, declining more than 20 percent over five years. That trend involves several factors including conservation efforts, substitution where feasible and the effects of economic doldrums. The impact of this major change in consumer behavior upon various gasoline marketers was masked from 1979 through early 1981 by the maze of price and allocation controls still imposed on the industry by the federal government. These regulatory distortions of the market allowed othewise uncompetitive segments of the industry to survive. At a stroke, however, decontrol of crude oil and product prices restored an openly competitive market.

Atlantic Richfield Company has achnowledged explicitly the dimensions of this openly competitive market environment. We have been among the first major oil companies to adjust actively to this new environment. We are not alone, as a survey of the market will testify. We do intend to remain competitive, despite the ire of some independent marketers who perceive they are disadvantaged by our marketing approach.

Atlantic Richfield, with only five percent market share in the national gasoline market, is not engaged in any program to eliminate competitors and then raise prices. Five percent market share is hardly monopolistic, especially given ease of market entry. We are competiting, however, for our place as a no frills, quality price marketer.

We are amazed at some of the marketing practice allegations that have been levelled at us. For instance, Atlantic Richfield certainly does not sell gasoline to its retail dealers throughout its marketing system at prices which are below the laid-in cost of crude—to do so would soon result in financial calamity! We do have a program for pricing to our dealers designed to help them remain competitive in small geographic areas in response to market pump pricing activity. The price in effect to our dealers in any given geographic area reflects a competitive price, less an amount which represents our savings resulting from elimination of our credit card.

Our ability to compete today in such a way results from a series of deliberate, strategic actions. During the last decade, we invested hundreds of millions of dollars to prepare our refineries to accept so-called heavy and sour crude oils and to be able to process those crude oils predominantly into higher-value products, namely gasoline and distillate fuels. We have consolidated our marketing territories, reduced our offices and pruned away unproductive assets, trying in every way to improve our marketing efficiency.

The most recent steps in our marketing strategy involved elimination of the Company credit card in April of 1982. We were not the first to recognize the cost of offering credit was increasing dramatically. We had watched our competitors experiment with discounts for cash, and so forth. We simply decided to eliminate credits cards entirely, since 70 percent of our gasoline sales were already for cash, in order to lower prices for our gasoline.

Our marketing strength, contrary to our critics' assertions, rests upon our ability to innovate, coupled with the efficiency of our refining and distribution system and the good business practices of our dealers. We know the American motorist has benefited from our approach. We see no reason why we should be penalized, in legislation or in regulation, for our competitive strategy in order that relatively uncompetitive participants be protected from the consequences of an open marketplace. When such anti-competitive policy is adopted, consumers usually face higher prices.

Mr. HANCE. Our panelists are Father Charles Currie, president, Xavier University, representing the National Association of Independent Colleges and Universities; George H. Nofer, president, American College of Probate Counsel; Brian O'Connell, president, Independent Sector; and Luis Granados, managing director, Employee Stock Ownership Association.

I apologize for our running so late.

Father Currie, we will hear from you first.

STATEMENT OF REV. CHARLES CURRIE, PRESIDENT, XAVIER UNIVERSITY, CINCINNATI, OHIO, REPRESENTING THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Reverend CURRIE. Thank you, Mr. Chairman.

Mr. Chairman and members of the Ways and Means Committee, I am Charles Currie, president of Xavier University in Cincinnati, Ohio. I am happy to be testifying today on behalf of the National Association of Independent Colleges and Universities, and several other national higher education groups, as noted on the cover sheet of my written testimony.

Together, these associations represent more then 2,000 public and independent colleges and universities across the country.

I am here to respond to Chairman Rostenkowski's tax freeze proposal. One part of that proposal calls for a $25 freeze on the charitable deduction for nonitemizing taxpayers. This deduction, enacted in 1981 as part of the Economic Recovery Tax Act, is scheduled to phase in between 1982 and 1986.

The ERTA provision starts with a maximum deduction of $25 in 1982 and 1983, working up to full deductibility of all charitable contributions in 1986, followed by a sunset provision.

Mr. Rostenkowski's freeze would allow a maximum of $25 per year until 1986, followed by a sunset provision. We submit that such a restriction would cause great harm to charitable organizations, and would be contrary to the intent of Congress to allow a phasein through 1986, when charitable contributions become fully deductible for nonitemizers.

Voluntary giving, which provides vital financial support for American colleges and universities and other charitable institutions, is encouraged by Federal tax laws that were enacted in recognition of the value of nonprofit charitable organizations to society.

The charitable deduction was incorporated into the income tax law of 1913 as a stimulus to encourage the giving of wealth for public purposes. Thus, Congress has for more than 65 years recognized the important services provided by charitable organizations in meeting public needs.

Private philanthropy has always been viewed as a cornerstone of our pluralistic society. As the Commission on Private Philanthropy and Public Needs, otherwise known as the Filer Commission, concluded in 1975:

> Not only do many specific nonprofit causes depend for their autonomy on such support and many beneficiaries of nonprofit services rely on such aid for their particular benefits, but the very character of American life depends on individuals' feelings of mutual obligation and the exercise of pragmatic altruism, which are expressed in and nurtured by private giving for public purposes.

Prior to the enactment of ERTA, only those who itemized deductions were able to deduct their charitable contributions. In recent years, due to changes in tax law, the number of itemizing taxpayers has decreased substantially, to a low of 33 percent in 1982.

Thus, fewer and fewer taxpayers have been able to take advantage of the charitable deduction. These changes have reduced tax incentives for giving, and caused losses to charitable groups.

In 1981, the charitable deduction was extended to all taxpayers. A general explanation of ERTA prepared by the Joint Tax Committee explained that:

> The Congress believed that allowing a charitable deduction to nonitemizers stimulates charitable giving, thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by the Federal Government.

Thus, Congress clearly recognized the sound tax policy and public policy arguments in favor of extending the charitable deduction to low- and middle-income taxpayers.

The three criteria commonly used to measure the value of a tax provision—efficiency, effectiveness, and equity—indicate the merits of retaining the above-the-line deduction for those taxpayers who use the short form.

The above-the-line deduction will be able to reach its full potential and serve its purpose only by phasing in to full implementation in 1986, and thereafter being made a permanent part of the Tax Code.

The deduction for nonitemizers is effective, as evidenced by annual increases in charitable giving. Research done in the late 1970's by Professors Michael Boskin and Martin Feldstein show that the extension of the deduction to nonitemizers would benefit charities.

The study concluded that:

> Tax incentives to encourage giving by low- and middle-income households would induce a substantial increase in the flow of funds to charitable organizations.

A very recent study by Charles Clotfelter of Duke University and Lester Salamon of the Urban Institute similarly shows that when the new deduction for nonitemizers is fully phased in, total giving should rise.

The theoretical tax policy arguments for extending the charitable deduction to every taxpayer rest on the notion that money voluntarily given to worthy public causes should not be counted as income in an income tax system that taxes a person in accord with his ability to pay.

A person's annual ability to pay tax is properly measured by his annual personal consumption and annual net accumulation of wealth. Charitable gifts contribute to neither personal consumption nor accumulation of wealth.

In the case of amounts donated to education and other charitable activities, the benefits produced have the character of public goods where consumption by one person does not preclude consumption by others.

No one individual should be taxed as if he had consumed the goods himself. Only a full exclusion of charitable contributions from the income tax base—through the allowance of a deduction of contributed amounts for all taxpayers—guarantees that individuals will not be taxed on amounts they devote to public use through philanthropic giving.

The public policy arguments for the deduction are also compelling. The Filer Commission noted in 1975 that the charitable deduction is the only expenditure for public purposes that each individual decides whether or not to make. The Government incentive to private giving should be recognized as a special deduction, broadly available to all taxpayers, on a voluntary basis, whether or not they use the standard deduction.

Research has shown that while giving is primarily governed by altruism, the availability of the charitable deduction clearly increases the size of the gift. In preparation for a recent forum which reviewed the 1975 findings of the Filer Commission, Charles Cotfelter wrote:

> While altruistic reasons may be most important, the most recent studies have shown that there is a price sensitivity with regard to charitable contributions.
>
> It is, of course, not the only reason why people give, but one implication of this finding is that explicit tax provisions aimed at encouraging contributions, such as extending the charitable deduction to nonitemizers, may be quite effective in increasing giving.

The charitable deduction is crucial to colleges and universities. Preliminary analysis shows that smaller gifts have increased as a result of the above-the-line deduction. Complete effectiveness cannot be achieved, however, unless the phasein continues as current law provides.

Mr. Chairman, the higher education community submits that the current law phasein schedule as enacted in 1981 should be maintained. We strongly oppose any type of cap or limit on the charitable deduction for nonitemizers.

We further assert that a $25 freeze would cause great harm to the charitable community, and would be contrary to the intent of Congress as enacted in the Economic Recovery Tax Act.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF CHARLES CURRIE, S. J., PRESIDENT, XAVIER UNIVERISTY, CINCINNATI, OHIO, ON BEHALF OF: AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES, AMERICAN COUNCIL ON EDUCATION, ASSOCIATION OF CATHOLIC COLLEGES AND UNIVERSITIES, ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES, COUNCIL OF INDEPENDENT COLLEGES, NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS OFFICERS, NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES, AND NATIONAL ASSOCIATION OF SCHOOLS AND COLLEGES OF THE UNITED METHODIST CHURCH

Mr. Chairman, and members of the Ways and Means Committee, I am Charles Currie, president of Xavier University in Cincinnati, Ohio. I testify today on behelf of the National Association of Independent Colleges and Universities, and several other national higher education groups, as noted on the cover sheet of my written testimony. Together these associations represent more than 2,000 public and independent colleges and universities across the country.

I am here to respond to Chairman Rostenkowski's tax freeze proposal. One part of that proposal calls for a $25 freeze on the charitable deduction for nonitemizing taxpayers. this deduction, enacted in 1981 as part of the Economic Recovery Tax Act (ERTA), is scheduled to phase in between 1982 and 1986. The ERTA provision starts with a maximum deduction of $25 in 1982 and 1983, working up to full deductibility of all charitable contributions in 1986, followed by a sunset provision. Mr. Rostenkowski's freeze would allow a maximum of $25 per year until 1986, followed by a sunset provision. We submit that such a restriction would cause great harm to charitable organizations, and would be contrary to the intent of Congress to allow a phase-in through 1986, when charitable contributions become fully deductible for nonitemizers.

Voluntary giving, which provides vital financial support for American colleages and universities and other charitable institutions, is encouraged by federal tax laws that were enacted in recognition of the value of nonprofit charitable organizations to society. The charitable deduction was incorporated into the Income Tax Law of 1913 as a stimulus to encourage the giving of wealth for public purposes. thus, Congress has for more than sixty-five years recognized the important services provided by charitable oranizations in meeting public needs.

Private philanthropy has always been viewed as a cornerstone of our pluralistic society. As the Commission on Private Philanthropy and public Needs, otherwise known as the filer Commission, concluded in 1975, "Not only do many specific nonprofit causes depend for their autonomy on such support and many beneficiaries of nonprofit services rely on such aid for their particular benefits, but the very character of American life depends on individuals' feeling of mutual obligation and the exercise of pregmatic altruism, which are expressed in and nurtured by private giving for public purposes."

Prior to the enactment of ERTA, only those who itemized deductions were able to deduct their charitable contributions. In recent years, due to changes in tax law, the number of itemizing taxpayers has decreased substantially, to a low of 33 percent in 1982. Thus, fewer and fewer taxpayers have been able to take advantage of the charitable deduction. these changes have reduced tax incentives for giving, and caused losses to charitable groups.

In 1981, the charitable deduction was extended to all taxpayers. a general explanation of ERTA prepared by the Joint Tax Committee explained that "the Congress believed that allowing a charitable deduction to nonitemizers stimulates charitable giving, thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by the federal government." Thus Congress clearly recognized the sound tax policy and public policy arguments in favor of extending the charitable deduction to low- and middle-income taxpayers.

The three criteria commonly used to measure the value of a tax provision—efficiency, effectiveness, and equity—indicate the merits of retaining the "above-the-line" deduction for those taxpayers who use the short form. The above-the-line deduction will be able to reach its full potential and serve its purpose only by phasing in to full implementation in 1986, and thereafter being made a permanent part of the tax code.

The deduction for nonitemizers is effective, as evidenced by annual increases in charitable giving. Research done in the late 1970s by Professors Michael Boskin and Martin Feldstein show that the extension of the deduction to nonitemizers would benefit charities. The study concluded that "tax incentives to encourage giving by low- and middle-income households would induce a substantial increase in the flow of funds to charitable organizations." A very recent study by Charles Clotfelter of Duke University and Lester Salamon of the Urban Institute similarly shows that "when the new deduction for nonitemizers is fully phased in, total giving should rise."

The above-the-line deduction is efficient. Data compiled by Martin Feldstein, currently chairman of the President's Council of Economic Advisers, show that every dollar of revenue foregone by the government through the charitable deduction yields approximately $1.19 in voluntary support for charitable institutions. In fact, while the deduction for nonitemizers is expected to generate $5.7 billion for charities, the Treasury would take in only $4.8 billion less when the deduction is fully implemented.

The deduction is equitable. The charitable deduction makes the tax system more progressive, because people in higher tax brackets tend to give a larger portion of their earnings than people in lower tax brackets. Thus, the charitable deduction distributes income more equitably in our society. The above-the-line deduction is especially equitable for those in low- and middle-income brackets, because it would allow every taxpayer to take a deduction for making charitable gifts for public purposes.

The theoretical tax policy arguments for extending the charitable deduction to every taxpayer rest on the notion that money voluntarily given to worthy public causes should not be counted as "income" in an income tax system that taxes a person in accord with his ability to pay. A person's annual ability to pay tax is properly measured by his annual personal consumption and annual net accumulation of wealth. Charitable gifts contribute to neither personal consumption nor accumulation of wealth. In the case of amounts donated to education and other charitable activities, the benefits produced have the character of public goods where consumption by one person does not preclude consumption by others. No one individual should be taxed as if he had consumed the goods himself. Only a full exclusion of charitable contributions from the income tax base—through the allowance of a deduction of contributed amounts for all taxpayers—quarantees that individuals will not be taxed on amount they devote to public use through philanthropic giving.

The public policy arguments for the deduction are also compelling. The Filer Commission noted in 1975 that the charitable deduction is the only expenditure for public purposes that each individual decides whether or not to make. The government incentive to private giving should be recognized as a special deduction, broadly available to all taxpayers, on a voluntary basis, whether or not they use the standard deduction.

Research has shown that while giving is primarily governed by altruism, the availability of the charitable deduction clearly increases the size of the gift. In preparation for a recent forum which reviewed the 1975 findings of the Filer Commission, Charles Cotfelter wrote, "While altruistic reasons may be most important, the most recent studies have shown that there is a price sensitivity with regard to charitable contributions. It is, of course, not the only reason why people give, but one implication of this finding is that explicit tax provisions aimed at encouraging contributions, such as extending the charitable deduction to nonitemizers, may be quite effective in increasing giving."

Another factor that influenced the decision on the above-the-line deduction was the federal budget. The Urban Institute estimates that charitable organizations will lose $25 billion in direct federal dollars from 1982 through 1985. These same organizations will see federal dollars shrink by $80 billion over the same period in areas of interest to nonprofit organizations. These cutbacks will cause an increased demand for social services. Therefore, if the federal government is decreasing direct dollars for charitable organizations while encouraging private initiatives, it must also offer incentives to do so through tax deductions. Those deductions must extend to all taxpayer to be fully beneficial.

The federal budget was also a factor in the decision by charitable organizations, in 1981, to support a five-year phase-in of the law rather than full deductibility in the first year.

The charitable deduction is crucial to colleges and universities. Preliminary analysis shows that samller gifts have increased as a result of the above-the-line deduction. Complete effectiveness cannot be achieved, however, unless the phase-in continues as current law provides. Colleges and universities are confident that the deduction for nonitemizers can be used to establish the "habit of giving" among young donors. As the deduction increases over the five-year period, those smaller givers are likely to increase their contributions. Again, the primary reason for giving is philanthropic, but the size of the gift increases because of the tax deduction.

Mr. Chairman, the higher education community submits that current law phase-in schedule as enacted in 1981 should be maintained. We strongly oppose any type of cap or limit on the charitable deduction for nonitemizers. We further assert that a $25 freeze would cause great harm to the charitable community, and would be contrary to the intent of Congress as enacted in the Economic Recovery Tax Act.

In the area of other revenue increase proposals, we would like to express our concerns about tax-exempt bond financing for student loans and educational facilities.

Last year, in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Congress recognized the public purposes that colleges and universities serve, requiring only reporting and registration in the case of student loan bonds or bonds for tax-exempt organizations. We supported those provisions and suggest that no new conditions exist that would indicate a need for further changes in the law. If there is a major tax bill this year, we ask Congress to reassert that recognition and continue the treatment of colleges and universities as stated in TEFRA.

There also has been discussion of ways to limit the issuance of tax-exempt bonds for private activities. Although student loan and educational facilities bonds have been recognized as distinct from private activity bonds, we again would like to express our concerns.

If a state-by-state volume cap were to be implemented and bonds utilized for higher education were to be included, the effects on colleges and universities could be substantial.

Many students travel from their homes to out-of-state colleges. The Guaranteed Student Loan program is available in the state of residence for use where the student attends college. To determine the appropriate state for purposes of a volume cap would be difficult. It also would be difficult to determine annual issuance of bonds for student loans since most are issued every two years for efficiency reasons.

As for facilities bonds, and perhaps in the case of student loan bonds, a state cap also would mean increased cost and delay. An approval process would probably be required, thus delaying construction of essential educational facilities, as well as issuance of loans to students. In addition, the costs associated with such a process would cause great concern for hard-pressed institutions of higher education.

For these reasons, and more importantly, because we have been recognized as distinct from private-purpose bonds, colleges and universities should be excluded from any volume cap.

Student loan bonds are the smallest measurable category of non-government tax-exempt bonds. In FY 1983, student loan bonds will have amounted to only 2.6 percent of all long term tax-exempt issues and 4.5 percent of all non-government-issued tax-exempt bonds.

With regard to bonds for educational facilities and equipment purchases, the revenue gains involved are so small that no government figures on them exist. They are too insignificant in volume for the Treasury to monitor revenue loss—a circumstance directly inverse to their enormous importance to the institution seeking affordable ways to build a dormitory, restore its structural facilities, or modernize its equipment.

The continued availability of tax-exempt facilities financing is extremely important for our institutions. In many cases, it makes the difference between succeeding or failing in a renovation or construction project It permits institutions to undertake crucial capital improvements, and also fills some of the gap caused by the termination of or reduction in low-interest government facility loan programs. It may allow construction when a project is needed, rather than when fundraising campaigns are concluded. It frequently makes possible renovations which produce more efficient facilities, reducing long-term energy and other operating costs; and many of these savings are directly reflected in lower costs for federally-supported research. And it can permit construction and renovation projects to proceed, providing desperately-needed stimulation to hard-hit local economies and small businesses.

Student loan bonds are equally as important as facilities financing bonds. Many students seeking assistance under the GSL program are eligible for guaranteed loans but do not have established banking relationships, and therefore have great difficulty obtaining GSLs. Many states don't enjoy the advantage of being money centers with sufficient capital to meet the GSL need by using funds held by commercial lending institutions; these capital-short states cannot meet the full student loan needs of residents without a supplementary source of capital.

Again, Mr. Chairman, we ask that current law as enacted by TEFRA be maintained, requiring both registration and reporting of bonds issued to finance student loans and educational facilities. We further ask that we not be included in any type of volume cap proposal.

Thank you for this opportunity to appear before the Ways and Means Committee on behalf of higher education.

Mr. HANCE. Mr. Nofer?

STATEMENT OF GEORGE H. NOFER, PRESIDENT, AMERICAN COLLEGE OF PROBATE COUNSEL

Mr. NOFER. Thank you, Mr. Chairman.

I am speaking on behalf of and as president of, the American College of Probate Counsel. Our organization has had the privilege of testifying before this committee ever since 1976 on every hearing related to estate and gift taxes.

We are appreciative of the opportunity to do so again today.

I am speaking on two very specific points. They relate to the scheduled increase of the unified transfer tax credit and the scheduled decrease in the top rates of estate and gift tax.

Our organization is composed of a little over 2,400 lawyers who specialize in the area of estate and trust matters. We feel that it is fair to say that we do not speak for any special interest group.

In the course of our practice, we represent taxpayers who have assets from the very small to the very large. There are two points that I will stress.

One is that we think the decision that was reached back in 1981, with the enactment of ERTA, was a correct one in setting up these two phase-in schedules. The second is a special plea that this area of the tax law requires a long-range stability contrary to what has been the practice, and has been the accepted practice, of other areas of tax law.

On the first point, the programed increase in the unified transfer tax credit will reach a point in 1987, if left undisturbed, where the exemption equivalent as we are prone to describe it, will be $600,000.

Presently, it has reached the point where it is $275,000.

That is to say, an accumulation of transfers of property, whether by gift or estate, that presently does not exceed $275,000, would pass free of estate tax. If the credit increases as is programed, we would reach the point where that figure would be $600,000.

I would like to mention in passing that although we talk in terms of this exemption equivalent being 600,000 in 1987, it does not mean it has the same effect for all size estates.

For example, a larger estate, a taxable estate of $3 million in 1987 would have an exemption equivalent of only $385,600. The $600,000 applies at the lower level.

This is because we are talking about a tax credit, and not a basic exemption. I mentioned that only so that when we talk about $600,000, we realize that this is not an across-the-board exemption for all estates. This is relevant because we feel it is correct to say that the essential purpose of the estate and gift tax is to have some limitation on the unusual accumulation of wealth, so that as it passes from generation to generation, there is some reduction in any unusual accumulation of wealth.

When this was examined back in 1981 with the enactment of ERTA, it was decided that $600,000 was a reasonable line to draw to differentiate between the small- or medium-sized estate and the estate that would represent some large accumulation of wealth. There are those who feel that it is still on the low side. But it was decided it was a fair line to draw.

What with inflation, what with sizable life insurance and indeed with the change that has already been made since that enactment in TEFRA, by not exempting more than $100,000 in qualified pension plans, it is not a large estate that reaches $600,000.

Many of the estates with farms, many of the small businesses, can easily reach this level without in any way representing a socially oppressive accumulation of wealth.

Therefore, we urge the Congress not to change the schedule. It was originally considered that $600,000 would be the amount. However, a phase-in was agreed to merely so that there would not be an unusual immediate shock to the tax revenue aspect.

If we stop in the meantime, we are stopping short of what was considered to be a reasonable line to draw.

Similarly, with the reduction in the rates that are programed to be reduced over the next remaining 2 years, so that the top rate would be 50 percent. We think it is more than a theoretical symmetry that this 50-percent level——

Mr. **Jacobs**. Mr. Granados, do you yield some of your time to Mr. Nofer?

Mr. **Granados**. Yes.

Mr. **Nofer**. I will be through very shortly.

With the reduction to the 50-percent rate, that this symmetry between 50 percent on the passage or transfer of property and the 50-percent top rate on the income earned from the property is a very proper comparison.

My final point is this: In this area of tax law, we think it is important that there be some long-range stability. People have to make plans for the disposition of their estates. For 20 years we had this stability, and ever since 1969, with the enactment of the Tax Act then, having to do with unitrusts, and then the 1976 Tax Reform Act, ERTA, TEFRA, the Tax Technical Correction Acts that have occurred in between them, the moratoriums, the unresolved regulations, have left this field in a very disturbed status.

Taxpayers who are quite ready to accept frequent changes in income tax become very upset when they find the changes in the estate tax, where their estate plans have to be reviewed just within a few years of what represented a substantial change in the enactment of the law.

We therefore plead that we now stick with the plans that have been worked out, and have some sense of long-range stability so that we can properly, without undue expense and constant reviews of state plans, work out plans for taxpayers in this field.

Thank you very much, sir.

[The prepared statement follows:]

STATEMENT OF GEORGE H. NOFER ON BEHALF OF THE AMERICAN COLLEGE OF PROBATE COUNSEL

My name is George H. Nofer, and I am testifying today on behalf of, and in my capacity as President of, The American College of Probate Counsel. My address and how I can be reached are as follows: George H. Nofer, Esq., 1719 Packard Building, Philadelphia, Pa., Tel. (215) 988-2464. Alternate: Arthur Peter, Jr., Esq., (202) 835-8196.

SUMMARY OF PRINCIPAL POINTS

(A) The College opposes a repeal of (1) the increases in the unified transfer tax credit scheduled for 1984 through 1987, and (b) the reductions in the top transfer tax rate scheduled in 1984 and 1985.

(B) These scheduled changes are an integral part of the policy considerations embodied in the Economic Recovery Tax Act of 1981 ("ERTA"), and have been relied on by taxpayers in planning their gifts and estates.

(C) To change them within only two years of enactment will raise havoc with many such plans, and distort carefully integrated estate and gift tax provisions embodied in ERTA.

(D) To freeze the unified tax credit at its present level will once again subject small and medium size transfers to taxation and expense, when they do not represent a threat of concentrated wealth.

INTRODUCTION

This statement has been prepared by the President and President-Elect of The American College of Probate Counsel (the "College") and by the Chairman of the College's Estate and Gift Tax Committee. The positions presented here have been specifically approved either by the Board of Regents or the Executive Committee of the Board of Regents of the College. The membership of the Board of Regents and the Estate and Gift Tax Committee of the College is listed on Exhibit "A" attached to this statement.

The College is grateful for being given the opportunity to appear before this distinguished Committee to express the views of our membership (which is composed of more than 2450 lawyers who specialize in the practice of estate and trust law and related tax matters) concerning revenue increase proposals, more particularly a proposal to repeal the increases in the unified transfer tax credit and the decreases in the transfer tax rates that are scheduled to take effect after December 31, 1983. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the date it was first organized over 35 years ago. There is no doubt that our estate and gift tax laws represent the most complex and expensive aspect of our system of property disposition, and we welcome and accept once again the challenge of working with the 98th Congress to find additional ways for improving and simplifying these laws.

Tax freeze proposal to repeal all tax reductions scheduled to take effect after December 31, 1983

One of the revenue increase proposals being considered by this Committee is a proposal that would repeal the increases in the unified transfer tax credit and the decreases in the top transfer tax rates that are scheduled to take effect after December 31, 1983. This repeal would freeze the unified transfer tax credit at $79,300, a figure that shelters the transfer of $275,000 in assets, and retain a 60 percent top transfer tax rate. If left unchanged, the scheduled increases in the unified transfer tax credit enacted by The Economic Recovery Tax Act of 1981 ("ERTA") would raise the credit to $192,800 by 1987 and thereby exempt transfers of $600,000 or less, and shelter in a somewhat lesser amount larger transfers.[1] The scheduled reduction in the top transfer tax rates, also enacted by ERTA, would reduce the 60 percent rate to 50 percent by 1985. The College opposes the proposal to freeze these scheduled increases in the unified transfer tax credit and decreases in the top transfer tax rates.

BACKGROUND

The Tax Reform Act of 1976 modified the estate and gift tax laws in numerous ways. One modification involved the estate tax exemption, which had been set at $60,000 since 1942. This Act unified the gift and estate tax laws into a single comulative transfer tax system that combines lifetime transfers and transfers at death. At the same time, the gift tax and estate tax exemptions were unified and converted to a tax credit of $47,000 which sheltered aggregate transfers of $175,625[2] from gift or estate taxes. This increased credit was phased-in over a period of five years, primarily because of revenue considerations. ERTA further modified the exemption from the gift and estate tax laws by increasing the unified transfer tax credit to an equivalent amount of $600,000,[3] to be phased-in during the period of 1982 through 1987, and by reducing the maximum transfer tax rate from 70 to 50 percent over a phase-in period of four years. If enacted, the tax freeze proposal repealing all tax reductions scheduled to take effect after December 31, 1983 would halt the phase-in of the exemption from gift and estate tax at an exemption level of $275,000, and would leave intact a top transfer tax rate of 60 percent.

DISCUSSION

In 1981 the College enthusiastically supported an increase in the estate and gift tax exemption. The College's support for this proposition was based principally upon the fact that increased exemptions remove estates below the exemption level permanently from the transfer tax system, in effect repealing federal estate and gift taxes for those estates. Despite the recent changes in the rates and exemption, it is obvious that the present federal transfer tax system, i.e., the combination of the gift, estate and generation-skipping tax laws, is overly complex and burdensome. Transfer taxes force far too many taxpayers to develop, with the assistance of knowledgeable but expensive advisors, complicated estate plans that frequently represent an unhappy compromise between the taxpayer's true wishes about the disposition of his or her property and tax realities. Moreover, during recent years numerous changes in our transfer tax laws have caused these estate plans, and the documents implementing them, to be reviewed and revised with greater frequency, adding to the expense incurred by these taxpayers. The upshot has been an increasing level of resentment on the part of the taxpayers concerning the frequent changes to our transfer tax laws. The same taxpayers who are accustomed to, and accept, constant changes in our income tax laws, expect stability in our transfer tax laws. More and more taxpayers are faced with this dilemma as inflation pushes additional estates into the transfer tax system, or operates to increase the tax burden of estates that are already in that system, all without a corresponding increase in the real value of the assets in those estates.

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[1] Although the exemption equivalent scheduled for 1987 is frequently referred to as $600,000, it is actually only $385,600 for an estate of $3,000,000 or more. This is due to the fact that we are dealing with a tax credit and not a true exemption. The current exemption equivalent frequently referred to as $275,000 is actually only $149,633 for an estate of $3,000,000.

[2] The same analysis would apply as stated in footnote 1 above.

[3] See footnote 1.

The question of whether, and how, transfers of property should be taxed is ultimately a political issue. This issue should be resolved, however, with the fundamental purposes of the gift and estate taxes in mind. Throughout the long and often checkered history of our federal gift and estate tax laws these purposes have been clouded by an ambivalence between adherence to the social policies underlying taxes and revenue considerations. Whatever one's view may be, a long range policy was adopted as recently as 1981 in the enactment of ERTA, striking a balance between these two approaches. To change only part of the "package" would distort this balance.

If a fundamental objective of the transfer tax law is to enhance equality of opportunity in this country by preventing the undue concentration of wealth and power in the hands of a few, the $275,000 level of exemption equivalent afforded by the unified transfer tax credit in 1983 is by any standard ridiculously low. In all too many estates the value of the decedent's interest in his or her home, household furnishings and other miscellaneous noninvestment assets exceed this amount. In other instances, the availability of insurance arrangements and employee benefit plans push many middle-management taxpayers, who though during their lifetimes may find it difficult to make mortgage payments, into estate tax brackets that are well-above the present level of exemption equivalent.

Consider, for example, a taxpayer with a $400,000 estate. Prior to the enactment of ERTA this taxpayer more than likely chose an estate plan that would split his estate into two parts, a marital deduction transfer and a bypass trust for the assets in his estate that would not qualify for the marital deduction. This split estate approach was frequently adopted to prevent the estate of the surviving spouse from being overfunded for transfer tax purposes. In view of the new unlimited marital deduction and the expectation that the exemption equivalent will be increased significantly, that taxpayer more than likely changed his will after 1981 to convey his entire estate to a surviving spouse, since it was reasonable to expect that an exemption equivalent of at least $600,000 would be in effect for the surviving spouse at the time of his or her death in 1987 or thereafter. If the exemption equivalent is frozen at today's level of $275,000, that same taxpayer will have to revisit his estate plan, and will undoubtedly revise that plan to the more complicated split estate approach that was in vogue prior to the 1981 transfer tax changes. This very common hypothetical illustrates how a taxpayer will have seen his estate plan change three times over a very short period of years. The expense involved is not insubstantial.

The scheduled increase in the unified credit and the scheduled decrease in the top rates that were an essential part of ERTA can fairly be looked upon as an acceptance by Congress of the principle that transfer taxes should not conflict with other basic social values, including "rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of ongoing enterprise, and supporting diversity in priorities." [4] Let us reexamine that decision.

While a case may be made that a system permitting transfers of enormous wealth from generation to generation breeds pensioners rather than entrepreneurs among the recipients of that wealth, an equally compelling case can be made for the proposition that transfers of reasonable amounts of assets provide a desirable continuity of economically productive capital in the private sector of the economy. If the owners of successful businesses are not disrupted from their affairs by transfer tax concerns, their energies will continue to be directed toward the pursuit of business opportunities, the creation of jobs and the improvement of the productivity of the nation. Again, viewed from this standpoint, the wisdom of imposing gift and estate taxes upon transfers of property at a level as low as $275,000 should properly be questioned.

In addition, the imposition of gift and estate taxes at low levels of wealth encourage owners of farms and small businesses to pursue special interest relief measures from the transfer tax. These special relief provisions overly complicate the transfer tax system and violate the fundamental rule of tax neutrality by providing an advantage to one group of taxpayers that does not inure to others. The best and fairest way to provide tax relief is through increases in the exemptions from the transfer tax and general rate reductions that apply to all taxpayers.

The level of the exemption equivalent establishes the line between taxable and nontaxable estates. The task of determining the appropriate exemption level is difficult and necessarily involves an arbitrary exercise of judgment by those charged with the responsibility of our tax laws. We submit, however, that it will be impossible to make a rational determination about the level of the unified credit unless this Committee first identifies the fundamental purpose for the gift and estate tax laws. Otherwise, a Congress that is struggling mightily with the complex problem of avoiding budget shortfalls will naturally focus upon the revenue impact of statutory changes in this area. We are concerned that a preoccupation with revenue considerations will necessarily force Congress to focus on a threshold level for the transfer tax system that does not provide sufficient relief for our farmers, ranchers, businessmen and other taxpayers who now control the economically productive capital in the private sector of the economy. If the fundamental purpose of our transfer tax laws is to implement certain socially desirable goals rather than to produce revenue, a decision that is based upon a preoccupation with revenue implications will inevitably miss the mark. The College urges that the amount of the unified credit established by ERTA be allowed to increase to the projected level of a $600,000 exemption equivalent. We feel that this level encourages the formation of private capital by providing an adequate incentive for estate accumulation, discourages the development of special interest relief measures, and, most importantly, removes from the transfer tax system those taxpayers whose estates should clearly be spared the agony of dealing with a necessarily complicated tax process.

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[4] Summary from American Assembly program on estate and gift tax laws, Atlanta, Ga., in December 1976.

It should also be noted that many nontax benefits ensue for taxpayers with smaller and medium sized estates from a substantially increased unified credit. First, and perhaps foremost, the documents needed to implement estate plans will be shorter, easier to understand and less expensive to prepare. These taxpayers will therefore have some idea of what they are doing when they execute wills and trusts, or administer estates. Furthermore, the necessity for many trust arrangements, which are now used solely to minimize estate taxes, will be eliminated. Many unsophisticated taxpayers are leery of such esoteric devices as trusts and would be relieved to know that they will not forfeit tax advantages by failing to use them. Last, but certainly not least, the energies of trusts and estates lawyers and professional fiduciaries can be redirected toward more useful and productive pursuits if they are relieved of the obligation of preparing complex estate planning documents for clients who do not understand or like them, and often as not highly resent the fees incurred in their preparation and implementation.

The College also feels strongly that the scheduled reduction in the top transfer tax rates to 50 percent should be left undisturbed. The equal partnership between the government and the family of a decedent represented by a 50 percent rate seems appropriate. There is also more than a theoretical symmetry between a top tax rate of 50 percent on property and the top tax rate of 50 percent that now applies to the income from that property. The same inflationary pressures that have led Congress in recent years to reduce income tax rates apply equally to the issue of the top transfer tax rates. From this standpoint it again seems appropriate to maintain comparable rate levels for the income tax and the transfer tax system.

Here again we come back to our initial point of how taxpayers have acted in reliance on the phase-in schedules of ERTA. Take the case of a widow whose husband died in 1982, and her age was such that her life expectancy would take her well beyond 1987. She could well have made irrevocable decisions to accept her husband's entire estate under the marital deduction (except for a small by-pass trust) on the expectation that at her death it would be subject to a maximum rate of 50 percent. Had she not been able to plan on this reduction in the top tax rate, she might well have decided to accept only a portion of here husband's estate under the marital deduction and deliberately subjected the rest to taxation, so as to keep both portions within a 50 percent or lower bracket. If the scheduled reduction is now repealed, she has lost her chance to alter her decision.

In short, estate and gift tax planning is complicated and inherently long range. In this particular area of the tax law our plea is for—if we may coin a phrase—stare enactis; some long range stability in our tax enactments.

Exhibit A.—The American College of Probate Counsel

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Mr. JACOBS. Mr. Granados, Mr. Nofer has used 1 minute and 20 seconds of your time. Therefore, you have 3 minutes and 40 seconds.

STATEMENT OF LUIS GRANADOS, MANAGING DIRECTOR, EMPLOYEE STOCK OWNERSHIP ASSOCIATION

Mr. GRANADOS. I am Luis Granados. I am the managing director of the Employee Stock Ownership Association, which is the national association of companies with employee stock ownership plans. We believe that Congress should keep the promise it made to increase the tax credit for employee stock ownership plans from one-half of 1 percent of payroll to three quarters of 1 percent of payroll, starting in 1985.

Employee ownership of business enterprises is an idea whose time has come. It is working in thousands of companies. It is not just an idea that looks good on paper. Spreading the ownership of capital among average working people is not a luxury for the Congress to be pursuing, but a necessity. There is an intense concentration of capital ownership in the country today. One percent of the people hold one-half of individually held capital, and 6 percent of the people own over 80 percent of it. And that concentration is only going to get worse as the thrust of modern technology shifts more of the burden of production away from the labor side of things toward the capital side.

The ESOP proposal is one of the few things the Congress has done in order to encourage a broadening of the distribution of capital ownership. We don't think it makes sense to be undercutting the ESOP program at this time.

Another thing we hear about is productivity. There is even a White House conference coming up this fall. The ESOP is one of the few things available that has a proven record of improving productivity in companies by giving the employees a reason to become more productive.

According to a University of Michigan study, productivity among ESOP companies is 50 percent higher than among non-ESOP companies. According to a University of Iowa study, while national productivity rates were declining by 3 percent in the late 1970's, productivity at that time among ESOP companies was rising by 3 percent.

Mr. Chairman, the ESOP Association recognizes that this committee does have the obligation of increasing revenues over the next 4 fiscal years. While we would, of course, like to see the ESOP area of the law remain untouched, it may become necessary for changes in the taxation of ESOP's. We are willing to work with the committee on reasonable proposals in this area.

We supported legislation last year offered by Congressman Frenzel—H.R. 6227—that would offer ESOP companies relief from some of the particularly difficult regulations governing ESOP's if those companies, in turn, agreed to forgo some of the tax benefits available to them. This is the sort of thing we would like to work on with the committee staff.

It is the sort of thing that would increase revenues for the Government without having this sweeping cutback to the program that has been contemplated by tax freeze proposal.

Thank you.

[The prepared statement follows:]

STATEMENT OF LUIS GRANADOS, MANAGING DIRECTOR OF THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION

My name is Luis Granados. I am the managing director of the Employee Stock Ownership Association, which is the national association of companies with employee stock ownership plans. We believe that Congress should keep the promise it made to increase the tax credit for employee stock ownership plans from one half of one percent of payroll to three quarters of one percent of payroll, starting in 1985.

Employee ownership of business enterprises is an idea whose time has come. It is a concept that not only looks good on paper, but is working quite well in the thousands of companies where it is being tried. It does not make sense for Congress to pull the rug out from under a concept that is working, that is growing, and that is strengthening the American economy.

Spreading the ownership of capital among average working people is a not a luxury, but a necessity. We cannot ignore the fact that capital produces income in the same physical and economic sense that labor does, and we cannot ignore the thrust of the technological revolution which is steadily shifting the burden of production away from the labor factor and toward the capital factor. Nor can we ignore the intense concentration of the ownership of productive capital: 1 percent of the people own over half of all individually held capital, and 6 percent of the people own over 80 percent of it. The steady shift of income away from people who earn through their labor power and toward the tiny minority of people who earn through their capital ownership will only accelerate if Congress fails to encourage the broadening of capital ownership through devices like the ESOP. Most of the social spending programs causing the federal deficit today are designed merely to treat the symptoms of this maldistribution of ownership; the ESOP program is one of the few remedies available for the disease itself.

Moreover, study after study has shown the validity of the common sense notion that when workers are given a "piece of the action" in their companies, they tend to do a better job. "Productivity" is the catchword these days, and there is even a White House Conference on Productivity coming up this fall. Well, our members have come up with a simple idea: give their employees a reason to improve their productivity, by giving them a stake in the company. According to a University of Michigan study, productivity among ESOP companies is 50 percent higher than among similar sized companies in similar industries. According to a University of Iowa study, while national productivity rates were dropping by 3 percent in the late 1970's, productivity among ESOP companies was rising by 3 percent. To talk so much about the need to improve productivity and then to curtail a program with a proven record of building productivity does not make much sense to us.

We hear a lot these days about what has been called the "fairness" issue—whether this Government is unduly sympathetic to the rich rather than to those who need its help the most. With the ESOP, we have a program that benefits average working people by giving them a small stake of capital ownership they probably never would have gotten otherwise. Yet with all the other tax preferences in the Code of exclusive benefit to those who have already accumulated large capital estates, it is the ESOP that gets singled out when it is time to raise someone's taxes.

Mr. Chairman, there are only three ways in which capital can be owned. (1) It can be owned by a small handful of wealthy individuals, as is largely the case in the U.S. today; (2) it can be owned by the government, as is the case in communist countries; or (3) it can be broadly owned by average working people, which is the direction in which the ESOP is leading us. Surely Congress prefers broad ownership, and not concentrated or government ownership. Thus, we believe that Congress would strengthen, not limit, incentives for broad ownership through ESOP's, if it had the opportunity.

The ESOP Association recognizes, however, the obligation of this Committee to try to raise $73 billion between fiscal year 1984 and fiscal year 1986. If it should come to pass that the Committee raises some of this amount from the ESOP area, we pledge to work with the Committee on reasonable proposals. For example, last Congress we supported Congressman Frenzel's bill, H.R. 6227. This legislation offered ESOP companies relief from a particularly onerous regulatory burden involving the voting of stock held by the ESOP, if the ESOP company would, in turn, forego some of the tax benefits available to ESOPs. We prefer, of course, not to forego any incentives, but we are willing to explore legislation like H.R. 6227.

To conclude, The ESOP Association: (1) opposes any freeze on the level of tax credits available for employee stock ownership plans; and (2) is willing to work with the Committee on reasonable proposals pertaining to increasing revenues from the ESOP area if certain regulatory burdens are eased at the same time.

Mr. Jacobs. Thank you.

Mr. Pease.

Mr. Pease. I have no questions.

Mr. Jacobs. Mr. Gibbons.

Mr. Gibbons. Father Currie, we are not unmindful of the valuable service you performed for this committee when you united in marriage our chief counsel and his wife. We appreciate that.

Reverend Currie. My pleasure, Mr. Chairman.

Mr. Gibbons. Seems to be taking very well.

Mr. Nofer, I am glad to hear you say we ought to leave those tax laws alone. I assume that also applies to the generation skipping tax.

Mr. Nofer. No, sir, it does not. I think we have reason to be selective in the reasons we have given for leaving these alone, and the reasons we feel that the generation skipping tax as now enacted should be repealed. They come from a different basis. Our concern about the generation skipping tax as it now exists is that it is unworkable, too complicated and the Treasury now agrees.

The question is what revisions, if any, should be made in it or how it should be better stated.

I thought you might ask that question. But I still think my answer is a valid one.

Mr. Jacobs. Mr. O'Connell, I beg your indulgence. I thought you had testified. Would you care to give your testimony now?

STATEMENT OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR

Mr. O'Connell. Surely.

I am president of the organization Independent Sector, which is a curious mixture of foundations, businesses with major giving programs, and the full range of voluntary organizations, from Catholic charities to Planned Parenthood, B'nai B'rith, the Audubon Society, and international groups. This curious mix has come together fairly recently to try to strengthen our national traditions and practices of philanthropy and voluntary action.

We have from the start been particularly interested in continuing the broad base of giving and volunteering, that we think is a very important part of the strength of the country. For that reason, we initially proposed to this committee—Mr. Conable and Mr. Fisher, and later Mr. Gephardt, picked up on the sponsorship of the charitable contributions legislation which is now a part of the law, through the passage of ERTA.

There are several aspects of Chairman Rostenkowski's proposed freeze that we think would terribly impact the intent of Congress and the concept of fairness as we approach the full implementation of the charitable contributions law which again allows for taxpayers to deduct their contributions.

The first point is that in keeping with the discussions of three years ago, we agreed to a 5-year phase-in, so that the amount that could be deducted this current year is only a maximum of $25. Having participated in that compromise, out of awareness of the revenue impact, we think it is now grossly unfair to say that even though we compromised and agreed to that 3 years ago, now there is going to be a freeze at the very low level of $25, almost inconsequential in terms of the intent of the legislation. That, I think, is just grossly unfair.

It also becomes grossly unfair as Government cuts back other programs and turns to voluntary organizations to pick up the slack. As we all take a look at the limitations of big Government, and we look at it from conservative and liberal points of view, we realize there is tremendous value in voluntary organizations cranking up local services. It is the ultimate contradiction to be cutting back Government programs and to expect that people can turn to voluntary organizations for help when in fact those voluntary organizations are not being assisted in every possible way in the encouragement of contributions.

I would submit in candor, sir, that those two matters, the idea of canceling out our agreement with the phase-in, and a failure to do everything possible to support increased contributions of voluntary organizations at a time when Government expects voluntary organizations to do more—I submit those are uncharacteristic inequities proposed by some members of this committee.

The last point I would like to make, Mr. Jacobs, in your capacity as chairman, is that more and more we recognize the value of pluralism and voluntary organizations, in providing services, in advocating rights. I think more and more as we have examined what has made this country special we acknowledge that the voluntary spirit is, indeed, one of the most precious aspects of our society. The charitable contributions legislation, now part of the law, was designed to send the signal from our Government that giving to the causes of one's choice is so important as to be essentially outside the tax system.

That encouragement is needed now more than ever if we are to sustain this voluntary impulse. Therefore, I strongly urge that there be no consideration of any kind of cap, on the charitable contributions law.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF BRIAN O'CONNELL, PRESIDENT INDEPENDENT SECTOR

SUMMARY

(1) The testimony will address the Chairman's tax freeze proposal which would repeal all tax deductions scheduled to take effect after December 31, 1983.

(2) Historically, tax policy has encouraged the development of voluntary organizations, including the deductibility of charitable gifts to support those institutions.

(3) While giving is primarily motivated by altruism, the availability of the charitable deduction increases the size of many gifts.

(4) If the Charitable Contributions Law for nonitemizers is frozen at the bottom of its phase-in progression, it's potential for increasing contributions will be largely eliminated.

(5) The $108 billion in federal cutbacks for 1982-86 in funding of human service programs have placed an enormous strain on nonprofit organizations to increase their services.

(6) Capping the Charitable Contributions Law would have the result of increasing income taxes for charitable nonitemizers, the vast majority of whom are lower- and middle-income families which contribute proportionately more than their fair share to charity. Half of the contributions to charity each year come from taxpayers with incomes under $20,000 a year. Eighty-three percent of the revenue lost to Treasury, when the Charitable Contributions Law is fully implemented in 1986, will go to contributors with incomes under $30,000 a year.

(7) Charities accepted a five-year phase-in of the Charitable Contributions Law in 1981 as part of an agreed upon compromise to cushion the revenue impact of the measure.

STATEMENT

I. Introduction and overview

My name is Brian O'Connell, president of INDEPENDENT SECTOR, a membership organization of 500 voluntary organizations, foundations and business corporations which have banded together to strengthen our national tradition of giving, volunteering and not-for-profit initiative.

Our Voting Members are organizations with national interests and impact in philanthropy, voluntary action and other activities related to the independent pursuit of the educational, scientific, health, welfare, cultural and religious life of the nation. The range of Members includes: Association of Junior Leagues, National Council of Churches, United Negro College Fund, Shell Companies Foundation, American Association of Museums, Boys' Clubs of America, Duke Endowment, American Enterprise Institute, Brookings Institution, Cleveland Foundation, Catholic Charities, Planned Parenthood, Wells Fargo Foundation, Audubon Society, Goodwill Industries, Ford Foundation, American Association of Retired Persons, Opera America, National Urban League, Council for the Advancement and Support of Education, Atlantic Richfield Foundation, American Association of University Women, YM & YWCA's, B'nai B'rith, Native American Rights Fund, American Cancer Society, Hallmark Cards, U.S. Committee for UNICEF, Organization of Chinese Americans, Camp Fire, National Puerto Rican Coalition and 468 other equally diverse organizations. The common denominator among this diverse mix is their shared determination that the voluntary and philanthropic impulse shall remain a vibrant part of America.

Historically, tax policy has encouraged the development of voluntary organizations. Since the Revenue Act of 1917 which created the income tax structure as we know it today, this encouragement has included the deduction of contributions. The deduction has provided a significant incentive for giving but even more importantly has served to remind all of us that it is the philosophy and policy of the people and our government that giving is an act for the public good that is to be fostered. These direct and indirect encouragements have helped to maintain and promote the enormous degree of pluralism and citizen participation that are among the country's most important characteristics.

The desire to do good and to improve the communities in which we live are among the larger and more significant motivations for giving but the tax deduction helps influence the size of many gifts and the regular reminder that charitable gifts are tax deductible makes it clear that giving is encouraged and applauded.

II. Impact of the freeze proposal on charitable contributions

Mr. Chairman, the Charitable Contributions Law for nonitemizers was enacted in 1981 to encourage increased charitable contributions to the several hundred thousand public charities in this country to aid them in carrying out their philantropic objectives. The value to society of the work of groups such as the American Red Cross, National Audubon Society, American Cancer Society, Catholic Charities, and similar groups is so well known that I will not elaborate here.

It is in recognition of the importance of groups such as these that Congress, since 1917, has allowed taxpayers to deduct the amount of their charitable contributions from their income tax base. However, it was not until 1981 that Congress corrected a serious inequity in the law which affected nonitemizing taxpayers who contributed to charitable organizations. In 1981, in the Economic Recovery Tax Act, Congress, for the first time, permitted the 60 million taxpayers who do not itemize their income tax to deduct part of their charitable contributions—a privilege that only wealthier persons had enjoyed until 1981. The new Charitable Contributions Law, phased in over a five-year period, affords encouragement to lower- and middle-income Americans to increase their support of causes of their choice.

If the Charitable Contributions Law were frozen on December 31, 1983, the maximum amount that a nonitemizing taxpayer could deduct for charitable contributions would be $25. The evidence so far, indicates that even this modest deduction motivates some increase in charitable giving. This evidence tends to confirm earlier research which concluded that the enactment of the Charitable Contributions Law, would stimulate greatly increased giving to charity. However, if the Law is frozen on December 31, 1983, at its current level, most of the potential the Law holds for encouraging greater giving to charitable organizations, will be lost.

The importance of the charitable deduction in influencing the size of charitable gifts has been clearly established.

In testimony before the Senate Finance Committee in January of 1980, Dr. Martin Feldstein, now Chairman of the President's Council of Economic Advisors, but in

1980 Harvard University Professor of Economics, stated: "The statistical evidence indicates that the stimulus is substantial: each 10 percent reduction in the price of [charitable giving] induces an increase of about 13 percent in the amount of giving. The analysis shows that the [Charitable Contributions Law] would raise giving by about $3.8 billion (at 1975 levels) while reducing tax revenue about $3.2 billion. The extra giving represents a 13 percent increase total contributions."

Before the same hearings, Charles T. Clotfelter, Associate Professor of Public Policy Studies at Duke University stated: "Because it would allow nonitemizers to deduct charitable contributions in calculating taxable income, the legislation would increase an incentive to give by reducing the net 'price of giving.' "

Michael Boskin of Stanford said, "I believe it is sensible legislation for a number of reasons. First, it would add substantially to charitable giving in sectors of our economy in a manner that is extremely efficient relative to alternative methods for doing so."

R. G. Penner of the American Enterprise Institute said, "With regard to the current charitable deduction, I have no doubt that giving would fall drastically if it were eliminated."

A 1982 Gallup Survey gives further evidence that the charitable deduction for nonitemizers will increase the amount that taxpayers contribute to charity. The survey found that on the average, itemizers gave almost 2½ times as much as those who took the standard deduction. The Gallup survey found that in all income groupings, itemizers consistently gave substantially more than nonitemizers.

III. The nonprofit sector's need for vastly increased charitable contributions

Projecting from Dr. Feldstein's 1980 estimates, the Charitable Contributions Law, when fully implemented in 1986, will stimulate an increase in charitable giving by $5.7 billion. Nonprofits desperately need those dollars. They are now struggling under an enormous burden created by direct cuts in their federal funding and from the huge increase of people turning to nonprofits for help, who had formerly received services from government programs that have also been cut.

The impact of these budget cuts on nonprofit organizations and people they serve is clearly documented in research that is presently being carried out by The Urban Institute. Their survey, conducted in 12 metropolitan and four rural communities across the country in late 1982, found that by far the most significant feature of the changes in federal policy enacted over the past two years has been the reduction in the federal funds allocated for a number of human service program areas.

For nonprofit organizations, these budget cuts present two major problems. First, they increase the need, or demand, for nonprofit services. Second, they reduce the funds nonprofits have to meet needs.

Congress has cut spending on programs on interest to nonprofits, after adjusting for inflation, by $13.6 billion in fiscal year 1982 and $13.5 billion in fiscal year 1983, below 1980 levels. The President's fiscal year 1984 budget proposals would reduce the value of federal activity in these areas by an additional $80.5 billion for fiscal years 1984-86. The total reduction over the five-year period fiscal years 1982-86, would be $108 billion below 1980 levels (after adjusting for inflation).

These reductions are heavily concentrated in the social welfare area, which includes social services, community development, and employment and training.

Mr. Chairman, I'd like to point out what these national statistics mean for Chicago. Preliminary results from the Urban Institute study of nonprofit organizations in Chicago point to the breadth of the impact of federal budget cuts on the nonprofit sector in Chicago. Over half of the nonprofit organizations receiving government support had already experienced declines in government funding by the end of 1982. Funding cuts were even more pronounced among certain types of nonprofits, including human service providers such as social service providers and organizations involved in legal services and advocacy, health services, mental health services, institutional or residential care, and housing and community development. All experienced declines in government funding that was a direct result of federal budget cuts. Detailed reports of the Chicago study and on the studies in the 15 other communities and states throughout the country, will be available in early Fall.

IV. Federal budget cuts and the revenues of nonprofit organizations

What makes the challenge that federal budget cuts have posed for nonprofit organizations so difficult, is not simply that they have increased the demands for nonprofit services. An equally important problem is that Congress has simultaneously reduced the revenues nonprofits have available to meet even pre-existing demands.

According to Urban Institute estimates, the budget changes already enacted by Congress translate into a reduction in the value of federal support for nonprofit organizations of almost $4 billion in fiscal year 82 and $4.7 billion in fiscal year 1983, below fiscal year 1980, levels. The President's recent budget proposals would reduce this an additional $23.1 billion in fiscal year 1984-86. By 1986, therefore, federal support for nonprofit organizations would be reduced y $27.8 billion or 22 percent below its fiscal year 1980 level.

To put these figures in context, I refer to The Urban Institute research which assessed the increase in private giving needed to compensate nonprofit organizations for these reductions in federal revenues and thus allow them to maintain their 1980 levels of activity.

If we take into account the level of private giving as of 1981, the anticipated rate of inflation, and the revenue losses that nonprofit organizations would sustain as a result of the budget chances already enacted or proposed, private giving would have to grow by at least 22 percent in 1982, 24 percent in 1983, and an excess of 30 percent in 1984, 1985, and 1986 to allow nonprofit organizations to maintain their 1980 levels of activity. This represents a rate or increase in private giving that is 2-3 times greater than any that has been recorded in recent history. Maintaining the scheduled phased-in for the charitable deduction for nonitemizers is desperately needed to close at least some of this enormous gap between need and contributions.

V. Fairness and the contributor with modest income

The people who make the greatest sacrifice in giving to charity are those of modest means. Fully one half of the $60 billion contributed to charity in 1982 came from families with incomes under $20,000 a year. The Gallup survey on Patterns of Charitable Giving by Individuals shows that low-income families give proportionately 2-3 times more of their income to charity than do wealthier taxpayers. It is that same group of low-income taxpayers who can not take the charitable deduction passed in 1981. It is only fair to continue to permit those taxpayers of modest means who are shouldering a disproportionate part of the load in supporting non-profits, to have the same deduction as the wealthy.

It is estimated that 83 percent of the revenue lost to the Treasury when the Charitable Contributions Law if fully implemented in 1986, will go to the contributors with incomes under $30,000 a year. A cap on the Charitable Contributions Law would put the low-income contributor to charity, who will have benefitted from the law, back in the same unfair position he was prior to enactment of ERTA in 1981. In effect, capping the Law will amount to a tax increase in 1984, 1985 and 1986 for this very deserving group of low-income contributors. They would not be permitted, if the law is capped, to take the scheduled increase in 1984, 1985, and 1986 in the deduction for their charitable contributions.

VI. Acceptance of the phase-in in 1981

In 1982 when ERTA was enacted, charities accepted a five-year phase-in of the Charitable Contributions Law, in order to do our part to assist with the deficit. This was at the very same time that charities were reeling from the first of the budget cuts.

Mr. Chairman, we believe that we have done even more than our share to hold down the deficit, by accepting a phase-in which will only slowly increase charitable giving.

Federal funds to nonprofits have been cut and federal human service funds to public agencies have been cut. Please don't cut human services more by freezing the Charitable Contributions Law.

Mr. JACOBS. Thank you, Mr. O'Connell.

So far as I can tell, Mr. Gibbons had no further questions. As is plain, there is a vote on the floor now. The panel has made a contribution to the record for which the committee is grateful. The panel is dismissed.

Mr. JACOBS. The next panel will be called when the sitting resumes in approximately 9 minutes.

Father Currie, we are well aware of your unusual contribution to the well being of the staff of the Ways and Means Committee.

Thank you.

[Brief recess.]

Mr. GIBBONS. I wonder if the members of the next panel would come forward, please.

This panel we have is the Securities Industry Association, Morgan Stanley, and the National Constructors Association.

Mr. JACOBS. Mr. Loverd.

Mr. LOVERD. Thank you very much.

Mr. GIBBONS. All statements of this panel will be included in the record in full.

STATEMENT OF ROBERT L. LOVERD, MANAGING DIRECTOR, THE FIRST BOSTON CORP., ACCOMPANIED BY TIMOTHY GEORGE, VICE PRESIDENT, GOLDMAN-SACHS; NICHOLAS A. REY, MANAGING DIRECTOR, MERRILL LYNCH, WHITE, WELD CAPITAL MARKETS GROUP; RICHARD L. GRAND-JEAN, MANAGING DIRECTOR, SALOMON BROS., INC.; AND M. BERNARD AIDINOFF, COUNSEL, ALL ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION

Mr. LOVERD. Thank you very much, Mr. Chairman.

My name is Bob Loverd. I am a managing director of The First Boston Corp. With me today are Mr. Tim George, a vice president of Goldman-Sachs; Mr. Nicholas Rey, a managing director of Merrill Lynch; Mr. Richard Grand-Jean, a managing director of Salomon Bros; and Mr. Bernard Aidinoff, Esq., a partner of the law firm Sullivan & Cromwell who is advising us on this matter.

We appreciate the opportunity to appear here today in our roll as members of a special Securities Industry Association subcommittee which also has as its member Morgan Stanley. Morgan Guaranty Trust Co. of New York is involved in the committee's activities as an interested observer.

We are here today to strongly endorse H.R. 3025, introduced by Members Gibbons and Conable. Our point of view is really quite simple.

First, this particular bill is one of two extremely important ways of maintaining and broadening U.S. borrower access to debt investors outside the United States. Second, I understand the committee is interested in our views on H.R. 3025 as a revenue enhancement measure. In that context we agree with the basic numbers that have been prepared by the Treasury Department indicating that this bill will indeed increase the Nation's revenues.

I might deal with the subject of revenue enhancement first.

Assistant Treasury Secretary Chapoton, in a letter which was published sometime recently, indicated that the Treasury Department estimated a revenue increase from H.R. 3025 of $35 to $50 million. We have tried to come up with our own independent estimate.

Mr. GIBBONS. Is that on an annual basis?

Mr. LOVERD. That is correct.

We believe that the $35 to $50 million estimate is reasonable and probably on the conservative side.

In attempting to come up with our own numbers, we started by trying to estimate gross incremental revenues to the Treasury. Although it is extremely difficult for us to determine what that number is, our approach is very straight forward. There are at the moment significant tax liabilities incurred by U.S. corporations in the Netherlands Antilles. Those tax payments to the Antilles Government are basically direct offsets against taxes which would otherwise be payable to the United States. Were H.R. 3025 passed, the U.S. Treasury would be able to recapture those revenues.

On the other hand, H.R. 3025 would eliminate U.S. withholding tax on interest paid to overseas persons, and that would involve some revenue sacrifice. We understand that the numbers prepared by the Treasury suggest that something in the order of $80 million of withholding taxes were collected in 1980 on interest. We believe that only a modest portion of that revenue would be foregone in the event that H.R. 3025 were passed because the bill would eliminate the tax only on certain types of interest payments.

Therefore, to reiterate, we agree with the Treasury's numbers, we think they are reasonable, and we believe that if anything, they stray on the conservative side.

Our committee, on the other hand, also wishes to express its views on other aspects of the bill which, we think, are of vital importance to this country.

As I indicated, we believe the United States should preserve and in fact broaden access by U.S. corporations and Government to overseas investors. The last time this committee had an opportunity to testify before the House was in June of 1980. And since that time, some very significant things have developed in international capital markets.

When we last testified, available data for 1979 reflected that the total amount of Eurodollar financing was $12.6 billion. Three years, later, in 1982, the volume of new issues amounted new to $42.9 billion. Moreover, for the first time in history in 1982, the Eurodollar bond market was the same size as the domestic bond market.

In 1979, U.S. corporations had raised $3.1 billion in overseas capital markets. Of crucial significance is the fact that, in 1982, that number exploded to $14.6 billion. It is plain that U.S. corporations have become progressively more reliant on overseas markets. In 1979, less than 10 percent of the funds raised by U.S. corporations were raised outside of the United States, and in 1982, the number approximated 28 percent.

There are a number of recent events which have created a significant amount of uncertainty among borrowers which are presently able to tap the foreign capital markets.

First, there is considerable uncertainty as to whether or not H.R. 3025 will be enacted, as we hope it will.

Second, the United States-Netherlands Antilles tax treaty is in the process of being renegotiated and there is some concern as to when and on what basis that treaty will be extended.

And third, district offices of the IRS have challenged certain of the outstanding Netherlands Antilles subsidiaries which have been used by U.S. corporations to borrow overseas.

The net result of these three uncertainties is that many U.S. corporations which would otherwise be eager to borrow in the Eurobond market are reluctant to do so. There are also other types of borrowers which have been deprived of access to that market. At the extreme and principal among them is the largest single issuer of coupon securities in the world, the U.S. Treasury.

Moreover, there are a number of potential borrowers which have expressed keen interest in tapping overseas capital markets but, for policy reasons, have been precluded from doing so. One of the most prominent among them has been FNMA.

We believe that these borrowers should have access to those markets, and overseas sources of capital will be increasingly important to U.S. borrowers in the future. Indeed, these markets may function as a pressure release valve.

Only yesterday in Mr. Volcker's testimony he made the following statement:

> We would be left with the prospect of Federal financing that would absorb through and beyond the mid-1980's a portion of our savings potential without precedent during a period of economic growth. To put the issue pointedly, the Government will be financed but others will be squeezed out in the process.

This is a concern that we share.

In a worst case scenario, there could be certain things which would disrupt capital markets both domestically and internationally.

For example, IRS district office activities could trigger a forced redemption of all the outstanding Eurobond issues which have been completed in recent years by U.S. corporations. The dollar volume of that financing is something in the area of $32 billion. To put that figure in context, consider that the average amount of corporate securities issued in the United States during each of the last 4 years was $39 billion. We believe that most of these outstanding issues would be called, if the IRS district office challenges were sustained. The impact on domestic markets obviously would be dramatic.

We might also consider the impact of limiting U.S. borrowers to domestic markets. In 1982, U.S. corporations raised $14.6 billion in capital markets outside the United States. That compares with a total amount of financing of $43.7 billion in domestic markets. Were those corporations which had borrowed overseas instead been obliged to finance domestically in 1982, the total amount of public financing by U.S. corporations would have increased 33 percent to $58 billion. Again, the net impact of denied access to capital markets outside the United States would have been to disrupt capital markets domestically and to increase interest rates for all borrowers—individuals, corporations, and the Treasury—to levels higher than were the case.

The position of the Securities Industry Association is quite simple. There are two ways to preserve access to overseas capital markets for U.S. borrowers of all types, including the Government. One is through a satisfactorily renegotiated Netherlands Antilles tax treaty.

Another way, a broader way, and a way that would open overseas markets to some of the borrowers currently denied access to that source of funds is H.R. 3025. We strongly support H.R. 3025 and hope that our presence today will in some way advance its progress through the Congress.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT L. LOVERD, MANAGING DIRECTOR, THE FIRST BOSTON CORP.; TIMOTHY M. GEORGE, VICE PRESIDENT, GOLDMAN, SACHS & CO.; NICHOLAS A. REY, MANAGING DIRECTOR, MERRILL LYNCH, WHITE, WELD CAPITAL MARKETS GROUP; AND RICHARD L. GRAND-JEAN, MANAGING DIRECTOR, SALOMON BROTHERS INC., ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

My name is Robert L. Loverd and I am a managing director of The First Boston Corporation. With me are Timothy M. George, who is a vice president of Goldman, Sachs & Co., Nicholas A. Rey, who is a managing director of Merrill Lynch White Weld Capital Markets Group, Richard L. Grand-Jean, who is a managing director of Salomon Brothers Inc. and M. Bernard Aidinoff, who is a partner of Sullivan & Cromwell advising us on this matter.

We appreciate this opportunity to appear before the Committee on Ways and Means and are here in our capacities as members of a special sub-committee of the Securities Industry Association which has as its primary objective the preservation of access to overseas capital markets by United States borrowers. In addition to our firms, Morgan Stanley is also a member of the committee; Morgan Guaranty Trust Company participates in the sub-committee in the capacity of an interested observer. Combined, these six firms lead managed 99 of the 133 dollar-denominated Eurobond issues completed by U.S. corporations in 1982.

We appear here to testify in favor of H.R. 3025 which was introduced by Messrs. Gibbons and Conable and would eliminate the 30% withholding tax on interest paid to foreign persons. We view H.R. 3025 as a means of significantly expanding access to overseas investors on the part of U.S. borrowers, and we support it in that context. Currently, American companies raise money abroad free of withholding tax by using Netherlands Antilles subsidiaries. Should H.R. 3025 not be enacted, it is imperative that this form of access to foreign investors be maintained. We do, however, understand that the immediate focus of this committee is on the impact of the proposed legislation on U.S. Treasury revenues. We are aware of the Treasury Department's estimate that H.R. 3025 would produce a revenue gain of some $35-50 million and we believe that the estimate is reasonable and conservative.

Current Law

Under current law, the United States imposes a tax of 30% on interest payments made to foreign investors. This tax is collected in its entirety by withholding at source. It is therefore called a withholding tax, although it is not analogous to the domestic withholding tax which is a means of advance collection of a tax otherwise due at a later date. Although the 30% rate may be reduced by existing tax treaties, such treaties as a practical matter are not relevant for debt obligations publicly offered outside the United States.

American debt obligations, burdened with this tax, must compete with securities sold in the Eurodollar bond market which are not subject to any so-called withholding tax*. The net effect of the U.S. tax, in most cases, would be to reduce the return to overseas investors on interest-bearing securities issued in the United States by up to 30%. This reduced return would make United States Government and corporate obligations decisively uncompetitive with alternative investments available in the Eurodollar bond market. The tax has created an insurmountable barrier to investment in United States Government and corporate debt securities by most foreign private individuals and institutions. As a practical matter, therefore, debt securities cannot be sold to foreign private sector investors if they are subject to the 30% withholding tax.

Although direct access to overseas investors is effectively precluded by the 30% withholding tax, U.S. corporations have been able to sell their debt securities outside the United States free of the withholding tax by means of indirect access through Netherlands Antilles subsidiaries. Netherlands Antilles subsidiaries have been employed for this purpose for almost 20 years. Funds raised by U.S. corporations in this manner amounted to $14.6 billion in 1982, up from $4.4 billion in 1980 and $1.5 billion in 1978; since 1974, over $32 billion of such overseas issues have been completed by U.S. corporations.

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* See the discussion of the withholding tax practices of other countries on page 8.

The Securities Industry Association Position

We are concerned that events might occur which would inadvertently result in the termination of future access to overseas capital markets and/or the prepayment of the approximately $32 billion of overseas issues which have been completed by U.S. corporations since 1974. We are aware that the U.S. Treasury Department is presently renegotiating the United States/Netherlands Antilles Tax Treaty. Separately, the Internal Revenue Service which had long approved the use of Netherlands Antilles subsidiaries, through its district offices has recently raised certain questions with regard to the application of withholding tax to interest paid on Eurobonds. This activity on the Service's part could have a substantial and adverse effect on U.S. corporations which have outstanding Eurobonds and on future borrowings in the Eurobond market. The SIA is concerned that the foregoing administrative developments, absent enactment of H.R. 3025, could produce severe financial consequences.

The SIA supports H.R. 3025 and wishes to focus your attention not only on its revenue impact but also on the size of overseas capital markets, the degree of U.S. corporate involvement in them and the extent to which continued access to those markets is in this nation's self-interest.

Revenue Enhancing Aspects of H.R. 3025

The SIA believes that H.R. 3025 will not only encourage the flow of foreign capital into the United States but will also result in a net increase in tax revenues to the United States. Regarding the latter subject, in a letter to the Hon. Sam M. Gibbons dated May 23, 1983, John E. Chapoton, Assistant Treasury

Secretary for Tax Policy stated that "direct issuance of Eurobond obligations by U.S. issuers, as envisioned by your proposal, would result in a net gain in U.S. revenues" and that "the net revenue gain from such an amendment to the Internal Revenue Code would on a conservative basis be $35 million, and could well be as much as $50 million."

The SIA has on its own considered the potential revenue gain which would result from enactment of H.R. 3025. By making the employment of Netherlands Antilles finance subsidiaries unnecessary, enactment of H.R. 3025 would eliminate payments of Netherlands Antilles income tax made by such subsidiaries which, in turn, would eliminate the foreign tax credit taken for such taxes and thereby increase U.S. tax revenues. The magnitude of the revenues thus raised is difficult to quantify with certainty, largely because the Netherlands Antilles income tax varies with the finance subsidiary's debt to equity ratio, use of proceeds and other factors. Notwithstanding these information constraints, the SIA believes that the Treasury Department's estimate of a $35-50 million revenue gain is reasonable and conservative.

Importance of Access to Capital Markets Outside the United States

The attached eight exhibits highlight the growth and current size of capital markets outside the United States and detail their increasing importance as a source of financing for American borrowers. If H.R. 3025 were not passed and if a suitable alternative means of accessing the Eurobond market free of withholding tax (such as a Netherlands Antilles subsidiary) were not available, overseas capital markets would be closed to future offerings by U.S. corporations and the following scenario might unfold:

Domestic capital markets would experience severe pressures. For instance, had the $14.6 billion of Eurobond issues completed during 1982 been sold instead in the domestic market, new issue volume in the latter market would have increased 33% from $43.7 billion to $58.3 billion. We believe that this supply could not have been absorbed in an orderly manner. In a sense, therefore, overseas markets have functioned as a pressure release valve during recent years.

The impact of these events would be particularly disruptive if pressures from the funding of present and future needs were combined at a point in time with the necessity of refunding the $32 billion of outstanding issues (see the fourth paragraph on the following page).

As many U.S. corporations which financed in the Eurobond market during recent years were of extremely high credit quality, their return to the United States could tend to squeeze lower quality issuers out of domestic markets.

The increase in the private sector's domestic funding activities would be in direct conflict with those of the U.S. government as it attempts to finance its budgetary deficit.

It is highly unlikely that any significant portion of overseas investment funds which would otherwise have been employed for the purchase of Eurobond obligations of U.S. corporations would find their way back to the United States. A portion of such funds might be temporarily deposited with banks. However, shortly thereafter they would be invested in the debt obligations of those non-U.S. issuers which have free access to international capital markets.

The net impact of this scenario would be that U.S. capital markets would experience severe volatility and that domestic interest rates would settle at levels above those which would otherwise prevail. Moreover, certain U.S. corporations would have diminished access to domestic capital markets.

In the event that U.S. withholding taxes were imposed on interest payments on presently outstanding Eurobond issues, the following events might occur:

Most of the $32 billion of Eurobond issues sold since 1974 would be prepaid by their issuers. Otherwise, these same corporations would be legally obliged to gross up their interest payments on outstanding Eurobond issues by as much as 43%.

Initially, these prepayments would be financed in U.S. dollars largely through bank loans and the issuance of commercial paper, primarily in the United States but also overseas. This would result in upward pressure on short term interest rates in the United States.

The balance sheet liabilities of impacted U.S. corporations would, by historical standards, reflect a sharp increase in short term debt and an equivalent decrease in long term debt. This would occur at a time when the short term debt to total debt ratios of U.S. corporations are at historically high levels - levels which have in part caused major American rating agencies to downgrade the credit ratings of many corporations.

To restore their balance sheet equilibrium, corporations probably would seek to refund their Eurobond issues with new domestic bond issues. As many of the offerings completed between 1974 and 1979 bear low coupons by today's standards, the interest expense of these corporations would increase (certain of the corporations with lower credit ratings might find it impossible to finance in domestic public or even private markets). While the refunding of issues completed during the 1980-82 high interest rate era might be completed at lower interest rates, such refundings would deprive overseas investors of their investment returns and could be expected to materially jeopardize relationships between the United States and the overseas investment community.

Domestic capital markets would experience severe dislocations and interest rates would, at least for a time, move sharply upward.

To put the $32 billion (plus accrued interest) refunding requirement in context, the average annual new issue volume of taxable fixed income securities in domestic capital markets in the 1979/82 period was $39 billion. Therefore, the refunding alone would be equivalent to almost one full year's activities in domestic capital markets.

Existing Withholding Tax Uncertainties

The present environment is one in which a number of private sector borrowers are reluctant to take advantage of the net-cost-of-money savings and to exploit other opportunities available in capital markets outside the United States because of the uncertainty related to the future withholding tax status of interest payments on such obligations. This uncertainly is attributable to (a) the unknown status of H.R. 3025, (b) the renegotiation of the U.S./Netherlands Antilles Tax Treaty and (c) the Internal Revenue Service challenges to the tax status of certain existing Netherlands Antilles subsidiaries.

Equally important is the fact that a number of very important sectors of the economy have been deprived of access to the vast funds available outside the

United States. In particular, the Federal National Mortgage Association, which has publicly stated its eagerness to tap those markets on behalf of American home buyers, has been denied the opportunity to do so. Moreover, the world's single largest issuer of coupon securities, the United States Treasury, is precluded by the U.S. withholding tax from directly attracting foreign private sector investors.

Importance of Encouraging Capital Inflows to U.S. Capital Markets

In 1982, foreign investors were the source of $17.2 billion of net purchases of Treasury and federal financing bank bonds and notes. Our experience suggests that the vast majority of these investments were made by foreign central banks which are exempt from U.S. withholding taxes. In the same year, foreign net purchases of U.S. corporate securities was a mere $1.5 billion. Private sector investors (as opposed to central banks) tend to be the principal purchasers of corporate securities; we believe that their absence from the U.S. corporate market is due to the existence of the U.S. withholding tax coupled with the availability of attractive investment alternatives outside the United States. Thus, H.R. 3025 would remove the most important obstacle to capital inflows.

While potential incremental flows in a non-withholding tax environment cannot be predicted with any precision, surveys performed several years ago by Merrill Lynch and Morgan Stanley estimated incremental flows into Treasury and corporate securities of at least several billion dollars. These figures do not necessarily constitute the net incremental flow to American borrowers which would result were U.S. withholding taxes eliminated. Were H.R. 3025 passed, it is likely that a significant portion of the $14.6 billion of funds raised by U.S. corporations in capital markets outside the United States in 1982 would not have been funded in that manner. Rather, most of those corporations would have elected to raise capital through SEC-registered offerings which would be sold, in part, to overseas investors. Thus, it is possible that under H.R. 3025, U.S. corporations would cut back on their new issue activities overseas and substitute for them domestic offerings which are sold in part to the same overseas investors which could have purchased the Eurobond issues.

Withholding Tax Practices Outside the United States

Debt obligations sold in the Eurobond market are invariably free of taxes withheld at the source. This freedom from withholding taxes may be based on a specific exemption for interest on specified foreign borrowings (as, e.g., in the case of Canada, France, the United Kingdom and Australia), on the absence of any withholding tax on interest (as, e.g., in the case of the Netherlands, Denmark and Finland) or on the use of foreign finance subsidiaries (as, e.g., in the case of Germany). Foreign countries whose issuers have borrowed in the Eurobond market without withholding tax include the following:

Algeria
Argentina
Australia
Austria
Brazil
Belgium
Canada
Chile
Columbia
Costa Rica
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
India
Indonesia
Israel
Iran
Ireland
Italy
Japan
Korea
Luxembourg
Malaysia
Mexico
Netherlands
New Zealand
Norway
Papua New Guinea
Philippines
Portugal
Singapore
South Africa
Spain
Sweden
Switzerland
Trinidad & Tobago
Thailand
United Kingdom
Venezuela
Yugoslavia

Borrowers in the Eurobond market also include international organizations (such as the World Bank and the Asian Development Bank) and multinational organizations (such as the European Investment Bank and the European Economic Community).

Conclusion

The SIA believes that continued and broadened access on the part of U.S. borrowers to overseas fixed income investors is of vital interest to this nation's financial health and that both H.R. 3025 and a suitably renegotiated U.S./Netherlands Antilles Tax Treaty could attain this objective. Of the two alternatives, H.R. 3025 is the broadest and the only one which would both facilitate capital flows into the United States and result in a net increase in U.S. tax revenues. As well, H.R. 3025 would tend to integrate the two principal dollar capital markets (the domestic market and the Eurodollar market) under U.S. influence, with the result that more Americans would find employment in this country's financial services sector.

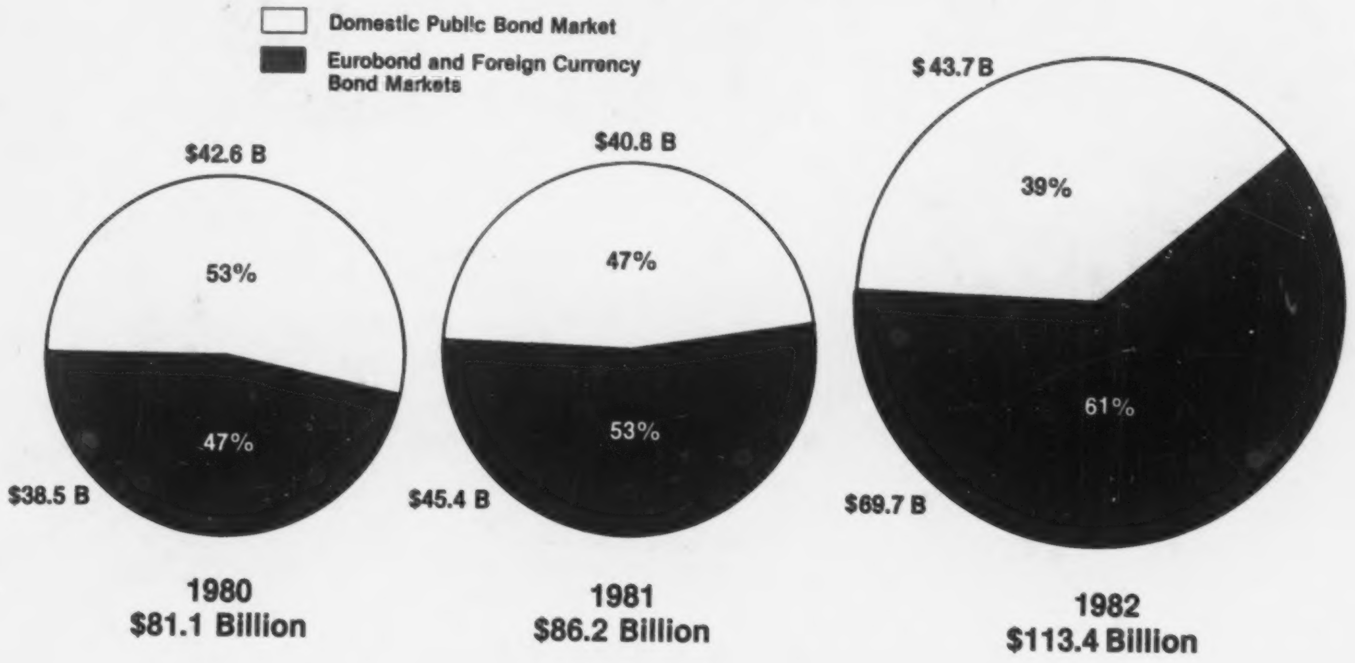
Thank you.

List of Exhibits

- Overview - Principal Capital Markets of the World
- Overseas Markets:
  - Currency of Denomination
  - Nature of Borrowers
- American Involvement in Overseas Markets:
  - New Issues by All Borrowers in the U.S. and Overseas Markets
  - New Issues by American Corporations in the U.S. and Overseas Markets
  - Overseas Issues by U.S. Corporations
  - U.S. Corporations which have Utilized the Dollar Sector of the Eurobond Market
  - Illustrative Cost Savings

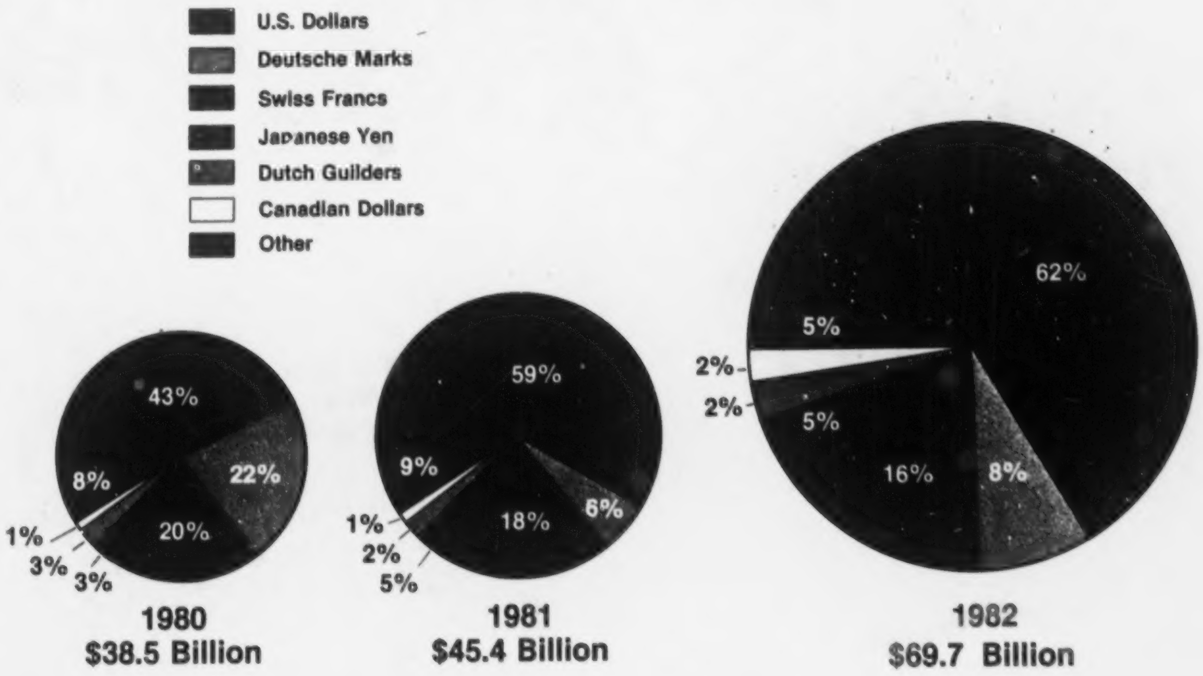
Principal Capital Markets of the World

Overseas capital markets accounted for 47% of funds raised in 1980 and 61% of a much enlarged market in 1982. Conversely, the domestic market shrank from 53% in 1980 to 39% in 1982.



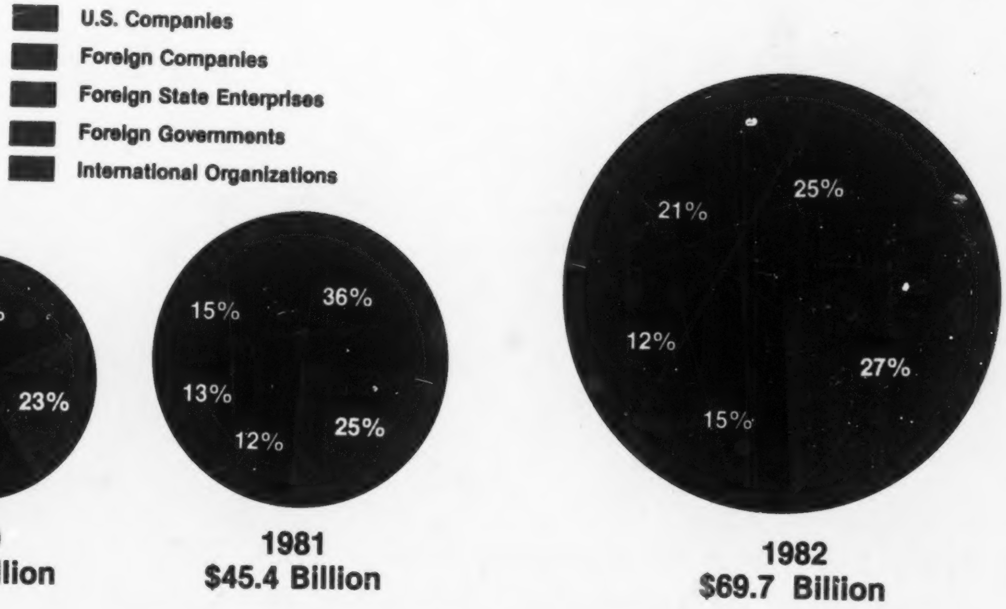
Eurobond and Foreign Currency Bond Market by Currency of Denomination

Between 1980 and 1982, total new issue volume in the Eurobond and foreign currency bond markets grew 81% and the share of U.S. dollar denominated issues increased from 43% to 62%.

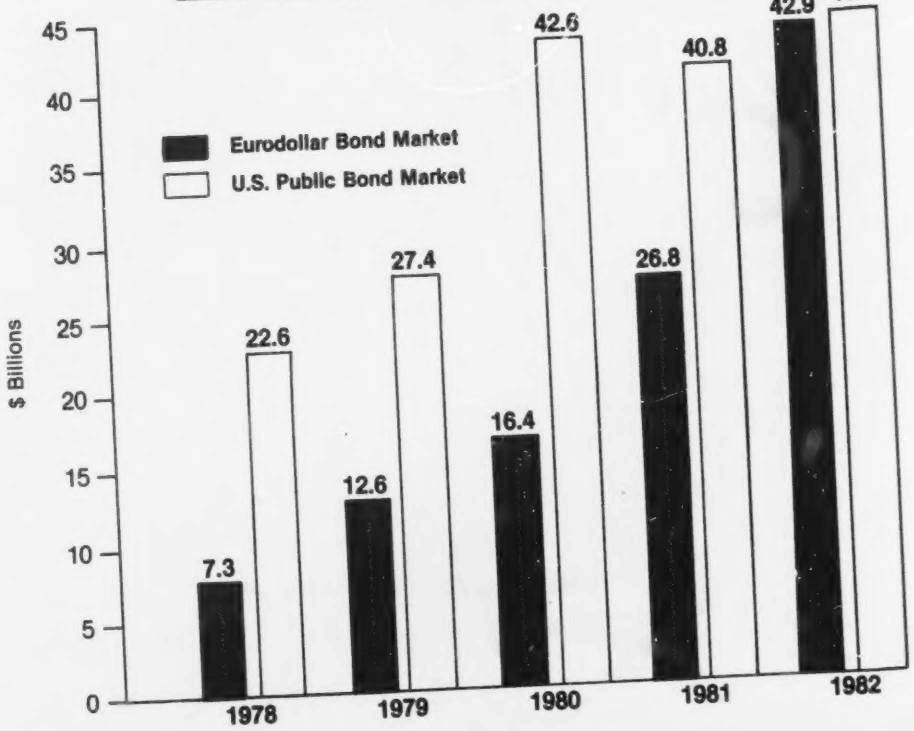


Nature of Borrowers in the Eurobond and Foreign Currency Bond Markets

U.S. issuers represented 11% of new issue volume in 1980 and 21% in 1982.



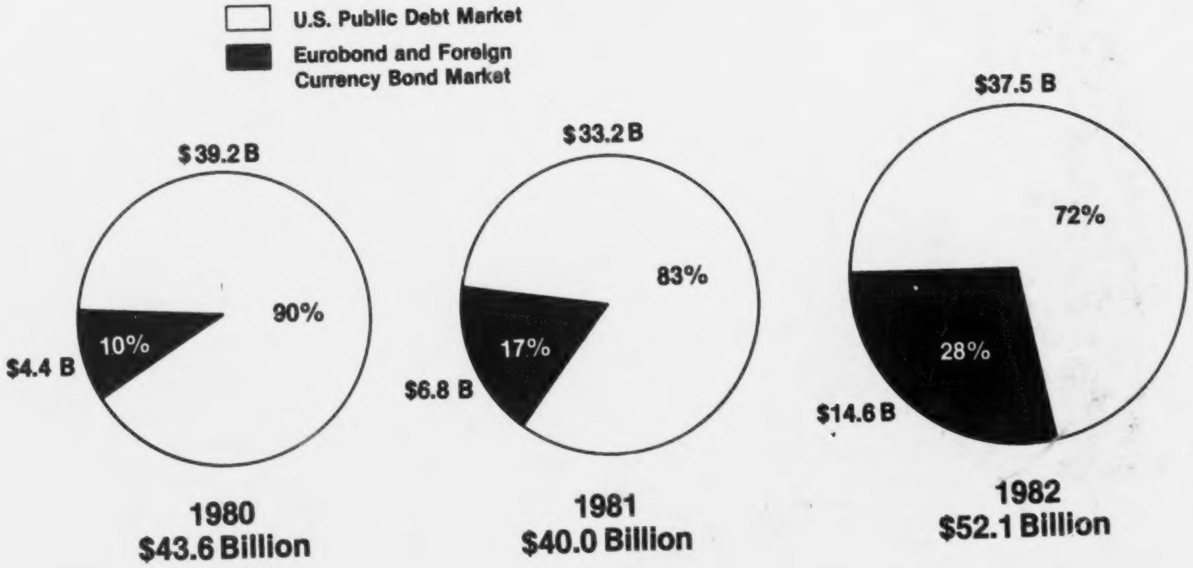
New Issues by All Borrowers in the U.S. Public and Eurodollar Bond Markets



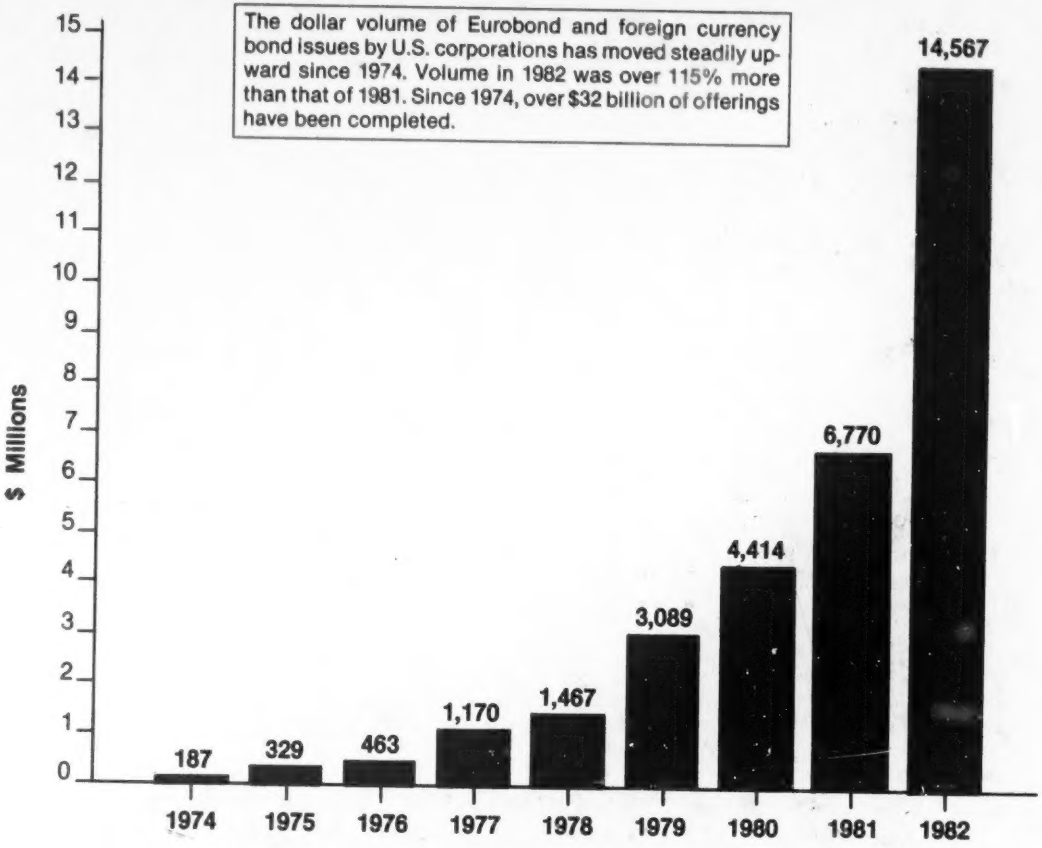
Although for many years domestic new issue markets were 2 or 3 times the size of their overseas counterparts, in 1982 for the first time the two markets were approximately the same size.

New Issues by American Corporations in the U.S. and Overseas Markets

Overseas capital markets have accounted for an increasing percentage of U.S. corporate public debt financing. In 1982, approximately 28% of public debt financing by U.S. corporations was completed in capital markets outside the United States.



Overseas Issues by U.S. Corporations



The dollar volume of Eurobond and foreign currency bond issues by U.S. corporations has moved steadily upward since 1974. Volume in 1982 was over 115% more than that of 1981. Since 1974, over $32 billion of offerings have been completed.

U.S. Corporations Which Have Utilized The Dollar Sector of the Eurobond Market

(January 1975 - December 1982)

A substantial number of U.S. companies have turned to the Eurodollar bond market as an alternative to the U.S. public market.

	Number of Issues	Dollar Volume (in millions)
Aetna Life and Casualty Company	1	150.0
Alaska Interstate	1	40.0
Alco Standard Corporation	1	30.0
Amax Inc.	1	75.0
American Airlines, Inc.	1	55.0
American Express International Banking Corp.	1	40.0
American Express Overseas Credit Corporation	1	75.0
American Medical International, Inc.	3	475.0
American Natural Resources Company	1	50.0
American Telephone & Telegraph Company	1	400.0
Anacomp Inc.	1	12.5
Anheuser - Busch, Inc.	2	200.0
Anixter Brothers Inc.	1	20.0
Apache Corporation	2	50.0
Arizona Public Service Co.	5	270.0
Armco Inc.	1	50.0
Ashland Oil, Inc.	1	60.0
Atlantic Richfield Company	2	700.0
Avco Corp.	2	45.0
Baker International Corporation	2	265.0
Bankers Trust New York Corporation	1	200.0
Bank of America	2	300.0
Beatrice Foods Co.	2	350
Beneficial Corporation	3	300
Blocker Energy Corporation	1	25.0
Burroughs Corporation	1	50.0
CPC International Inc.	1	50.0
Campbell Soup Company	2	250.0
Carolina Power & Light Company	1	80.0
Carter Hawley Hale Credit Corp.	1	50.0
Caterpillar Tractor Co.	3	540.0
The Charter Company	1	50.0
Chase Manhattan Corporation	1	150.0
Chemical New York Corporation	1	150.0
Citicorp	15	2,651.5
Cities Service Co.	1	150.0
City Investing Co.	2	80.0
Coca-Cola Bottling Company of New York Inc.	1	30.0

	Number of Issues	Dollar Volume (in millions)
The Coca-Cola Company	1	100.0
Commercial Credit Corporation	1	50.0
Community Psychiatric Centers	2	30.0
The Continental Group, Inc.	1	100.0
Continental Illinois Corporation	3	450.0
Crocker National Bank	1	225.0
Crutcher Resources Corporation	1	30.0
Digicon Inc.	1	18.0
Walt Disney Productions	2	175.0
Dow Chemical Co.	1	200.0
Dresser Industries, Inc.	1	75.0
Duke Power Company	1	60.0
Dynalectron Corporation	1	15.0
E.I. duPont de Nemours	6	1,315.0
ENSERCH Corporation	1	50.0
Esterline Corporation	1	20.0
Fairchild Camera and Instrument	1	20.0
First Chicago Corporation	1	100.0
First National Boston Corporation	1	100.0
Fluor Corporation	2	150.0
Ford Motor Company	2	450.0
Ford Motor Credit Company	3	450.0
Fruehauf Corp.	1	20.0
Fuqua Industries Inc.	1	50.0
Galaxy Oil Company	1	15.0
Galveston-Houston Company	2	30.0
Gearhart-Owen Industries Inc.	1	30.0
General Electric Credit Corporation	6	1,800.0
General Foods Corporation	1	100.0
General Motors Acceptance Corp.	15	2,275.0
General Motors Corporation	2	200.0
General Telephone & Electronics Corporation	7	380.0
Georgia-Pacific Corporation	1	65.0
Getty Oil Company	1	125.0
Goodyear Tire & Rubber Company	1	75.0
Gould Inc.	2	70.0
W.R. Grace & Company	1	75.0
Gulf States Utilities Company	2	120.0
Gulf Oil Corporation	4	675.0
Gulf & Western Industries, Inc.	4	135.0
The Hertz Corporation	1	50.0
Helmerich & Payne, Inc.	1	60.0
Hexcel Corporation	1	10.0
Hospital Corporation of America	2	105.0
Household International, Inc.	1	100.0
Huffy Corporation	1	10.0
IC Industries, Inc.	4	220.0
INA Corporation	2	100.0
IU International Corp.	2	65.0

	Number of Issues	Dollar Volume (in millions)
Illinois Power Company	1	50.0
Ingersoll - Rand Co.	1	50.0
International Business Machines Corp.	5	660.0
International Harvester Co.	1	115.0
International Standard Electric Corporation	1	100.0
International Telephone & Telegraph Corporation	1	75.0
Itel Corp.	2	55.0
John Hancock Mutual Life Insurance Company	1	75.0
J.P. Morgan & Co. Incorporated	1	250.0
K - Mart Corp.	2	136.0
Kansas Gas and Electric Company	1	40.0
Kay Corporation	2	35.0
Kennecott Corp.	1	100.0
Kidde, Inc.	1	50.0
Lear Petroleum Corporation	2	70.0
Lifemark Corporation	1	25.0
MGF Oil Corporation	1	35.0
McDonnell Douglas Corp.	2	90.0
McGraw - Edison Co.	1	75.0
Manufacturers Hanover Corporation	3	300.0
Marine Midland Banks, Inc.	1	125.0
Marion Corporation	1	20.0
Massey - Ferguson Inc.	2	115.0
Marriott Corp.	1	12.5
Merrill Lynch & Co., Inc.	2	200.0
Miles Laboratories, Inc.	1	20.0
Mobil Oil Corporation	1	500.0
Montana Power Company	2	100.0
Moran Energy Inc.	1	50.0
NICOR Inc.	1	50.0
Natomas International Corporation	3	150.0
Newmont Mining Company	1	50.0
The New York Times Company	1	50.0
Niagara Mohawk Power Corp.	1	50.0
Northern Indiana Public Service Co.	1	50.0
Northwest Energy Company	1	40.0
Northwest Industries, Inc.	1	50.0
Northwest Natural Gas Company	1	40.0
Oak Industries	1	35.0
Occidental Petroleum Corp.	7	350.0
Ohio Edison Co.	2	125.0
Optical Coating Laboratory Inc.	1	15.0
Pacific Gas & Electric Co.	3	180.0
Pacific Lighting Corp.	1	65.0
Pembroke Capital Company Inc.	2	300.0
Pengo Industries Inc.	1	22.5
J.C. Penney Company, Inc.	4	650.0
Pennwalt Corp.	1	25.0
Pennzoil Corporation	1	75.0

	Number of Issues	Dollar Volume (in millions)
Pepsico, Inc.	5	475.0
Philip Morris Credit Corporation	1	200.0
Phillips Petroleum Company	1	200.0
Portland General Electric Co.	2	100.0
Prudential Funding Corporation	1	150.0
Public Service of New Hampshire	1	30.0
Reading & Bates Corp.	1	25.0
Republic Steel Corp.	1	100.0
R.J. Reynolds Industries, Inc.	3	560.0
Reynolds Metals Company	1	60.0
The Saint Paul's Companies, Inc.	1	75.0
Santa Fe International Corp.	2	50.0
Sears Roebuck and Co.	4	1,050.0
Security Pacific Corporation	1	100.0
The Singer Company	1	50.0
South Carolina Electric & Gas Co.	1	60.0
Southern California Edison Co.	6	375.0
Southern California Gas Supply Co.	1	50.0
Spectra-Physics, Inc.	1	15.0
Sperry Corporation	1	100.0
Standard Oil Co. (Indiana)	1	75.0
Sundstrand Corporation	2	45.0
The Superior Oil Company	2	225.0
Tenneco Inc.	2	200.0
Texas General Resources, Inc.	1	12.0
Texas International Airlines, Inc.	3	90.0
Tosco Corporation	1	50.0
Trailer Train Co.	1	40.0
Transamerica Corp.	2	125.0
Transco Companies	2	100.0
Trans-Western Exploration Inc.	1	10.0
Tribune Co.	1	50.0
Triton Oil & Gas Corp.	1	20.0
Tyco Laboratories	2	32.0
U.S. Leasing International, Inc.	1	20.0
Union Carbide Corporation	1	150.0
Union Camp Corporation	1	70.0
United Technologies Corporation	1	100.0
Varco International Inc.	1	20.0
Jim Walter Corporation	1	25.0
Wang Laboratories, Inc.	1	40.0
Walt Disney Productions	2	175.0
Warner-Lambert Company	1	100.0
Wells Fargo & Co.	4	325.0
Xerox Corporation	1	100.0
Xerox Credit Corporation	1	250.0
Xidex Corporation	1	20.0

Illustrative Cost Savings in the Eurodollar Bond Market

1982

In addition to diversifying their funding sources, many corporations have tapped overseas markets because dollar funds were available on a lower cost basis than domestically.

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
11/18	**Arizona Public Service Company**	60	7	55
11/18	**General Foods Corporation**	100	12	44
11/17	**Bank of America Corporation**	100	7	108
11/17	**Gulf Oil Corporation**	100	12	90
11/16	**E.I. du Pont de Nemours**	100	12	51
11/11	**Coca Cola Company**	100	5.5	15
11/10	**General Electric Credit Corporation**	200	7	79
11/10	**Warner-Lambert Company**	100	7	43
10/19	**Superior Oil Company**	100	10	83
10/18	**Southern California Edison Company**	75	8	20
10/12	**The New York Times Company**	50	5	19
10/04	**United Technologies Corp.**	100	7	29
10/01	**Dresser Industries**	75	7	20
9/21	**Walt Disney Productions**	75	7	86
9/21	**Gulf Oil Corporation**	100	5	49
9/21	**Prudential Funding Corporation**	150	5	16
9/20	**Coca-Cola Company**	100	7	117
9/10	**General Electric Credit Corporation**	100	7	149
9/10	**RJ Reynolds Industries, Inc.**	100	7	97
9/09	**IBM World Trade Corporation**	200	10	63
8/17	**Southern California Gas Corp.**	50	7	24
8/16	**Sperry Corporation**	100	7	26

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
8/12	**Pacific Gas and Electric Company**	60	8	47
8/06	**General Motors Acceptance Corporation**	100	6	36
5/19	**The Superior Oil Company**	125	7	57
5/19	**Illinois Power Company**	50	7	59
5/17	**Northwest Natural Gas Company**	40	10	14
5/14	**First National Boston Corporation**	100	7	73
5/12	**General Motors Acceptance Corporation**	100	5	18
5/05	**General Motors Acceptance Corporation**	125	7	30
4/26	**Union Carbide Corporation**	150	7	31
4/23	**Southern California Edison Company**	75	7	63
4/16	**Getty Oil Company**	125	7	106
4/15	**Phillips Petroleum Company**	200	7	74
4/15	**The Hertz Corporation**	50	7	15
4/07	**Campbell Soup Company**	50	7	100
4/06	**Bank of America NT and SA**	200	5	89
3/30	**Gulf States Utilities Company**	60	8	78
3/25	**Pacific Gas and Electric Company**	45	7	53
3/10	**American Telephone & Telegraph Company**	400	7	46
2/19	**Continental Illinois Corporation**	100	7	14
2/11	**Arizona Public Service Company**	25	7	69
2/10	**General Motors Acceptance Corporation**	150	6	42
2/10	**McDonnell Douglas Finance Corporation**	50	7	8
1/26	**Arizona Public Service Company**	75	7	111

*The indicated savings compare the net cost of money on the Eurobond issue with what, in the SIA sub-committee's best judgment, would have been the net cost of money for an instrument of identical maturity in the domestic public market.

Mr. GIBBONS. Thank you. Do other members have statements?

STATEMENT OF JOHN C. EVANS, ADVISORY DIRECTOR, MORGAN STANLEY & CO., INC.

Mr. EVANS. Mr. Chairman, my name is John C. Evans. I am an advisory director of Morgan Stanley & Co., Inc., which is an international investment banking firm based in New York. I have been involved in the securities business for 36 years, in international investment for 27 years, and in the Eurobond market since its inception almost exactly 20 years ago. Part of this time I was in charge of Morgan Stanley's overseas financing operations.

I strongly support H.R. 3025, the Gibbons-Conable bill, which would eliminate the tax on interest paid to foreign portfolio investors in U.S. bonds; that is, foreigners who lend us money on a long-term basis. There is, of course, no tax on interest paid to foreigners who lend us short-term money.

I wish specifically to address the revenue consequences of this bill to the U.S. Treasury.

First, while I understand that the Treasury must be conservative in its own estimates of the revenue consequences, I should point out that there is apparently no way to get the figure for taxes actually collected that would be eliminated by this bill. It was necessary therefore to start with the total tax collected and deduct certain amounts, which could be identified, that would not be eliminated by the bill. Also, I do not believe that tax paid on the Treasury's own so-called Carter bonds, which tax the Treasury added to the interest rate and in effect pays to itself, has been deducted.

In trying to get at the revenue gain that would result from this bill, we have tried to identify some types of foreigners who would have bought U.S. domestic bonds and paid the tax, which tax would therefore have to be deducted from the revenue gain resulting from the elimination of foreign tax credits by the Gibbons-Conable bill.

None of the five leading firms in our industry, which together accounted for almost 70 percent of all new corporate bonds issued in the United States in 1982, and who also, taken together, represent a majority of secondary market trading, has been able to find such foreigners in any significant number. That is not surprising because such a person would have to seem to act irrationally. Who would buy a domestic GMAC bond and pay a 30-percent tax when there are plenty of tax-free GMAC bonds—more than $2 billion—outstanding in the offshore Eurobond market? The bottom line is that we think the actual net revenue gain is likely to be nearer to twice the Treasury's conservative estimate.

In fact, we continue to get evidence from bank-paying agencies and securities firms. We have seen no evidence to date that would cause us to change our own estimate. We are not suggesting that our estimate should have official standing, but merely that gives comfort that the Treasury estimate does not gild the lily.

Second, as the Treasury can attest, the Gibbons-Conable bill will enable it to know more about where the interest payments are going and will empower the Treasury to reimpose the tax, which functions as a virtually 100 percent effective protective tariff, on those countries which do not satisfy the Treasury that they are not parties to evasion by U.S. taxpayers. One bad bank, in other words, can put all other banks in the same country, and their clients, out of the U.S. domestic bond business. The pressures for self-policing are evident.

Third, it is our opinion that the principal beneficiaries of foreign capital that would be permitted into the United States by Gibbons-Conable would be U.S. Treasury notes and bonds. These incremental funds would not only assist in financing our deficits but, coming at the margin, would tend to lower the Treasury's long-term borrowing costs. The latter, I would submit, has the same effect as a revenue gain.

In short, we believe that the Gibbons-Conable bill can only be beneficial to the Treasury's net revenue.

We also believe that the bill presents a rare opportunity to do the country some real and important good while enhancing tax revenues. The 30-percent tax that would be eliminated was enacted decades ago. Foreigners did not buy our bonds, therefore, and did not owe any tax. This was not important for many years because we did not need the long-term debt capital and foreigners did not have that much of it available. That has changed now. In fact, it has flip-flopped.

To understand why, you must first understand what has happened to the dollar bond markets of the world in the last few years, particularly the tax-free Eurobond market.

The Eurobond market is truly an international market. Although the actual work of preparing and placing new bond issues in this market is centered in Europe—hence the name—the market itself has no nationality. It is virtually worldwide as to issuers and investors. While it used to be a pale shadow of our own vaunted domestic corporate bond market, it has grown rapidly in recent years. In 1982, the U.S. dollar-denominated sector of this offshore market, believe it or not, reached the same size in new issue volume as our own bond market.

My own firm, which is a leading manager and trader of issues in both markets, now has more people in our London office than we had in the whole firm 15 years ago, and very few of our London people are Americans. We have been forced to export jobs to remain competitive.

As in our domestic market, the Eurobond market during this recent period has become more and more institutionalized. The investors, in other words, are not very dissimilar to those that form the backbone of our U.S. market.

H.R. 3025 would, to a large extent, reintegrate the two huge dollar bond markets under U.S. control, with considerably more of the work being done in the United States by Americans.

I should make clear that we are not talking about creating a shift into dollar bonds, and therefore into dollars, from other currencies. The dollars are already out there and our short-term Treasury bills, bank CD's and commercial paper, which are free of the tax under present law, are the depositories for funds that respond to short-term interest rate and exchange rate expectations. We are talking about making our long-term domestic bonds available as vehicles for stable investment.

Why would foreigners buy our domestic bonds if the tariff were eliminated by this bill? The main reason is that, in spite of the size of the Eurobond market, our own market is much more liquid. Investors will sacrifice yield for liquidity and will buy our bonds at somewhat lower interest rates. Also there are no U.S. Treasury bonds in the Eurobond market. The only way foreigners can buy them now is to do so after an interest payment date and sell them before the next. There is no way they can afford to hold the only risk-free, long-term dollar investment.

It has been asked whether it would be possible to gain the same benefits by reducing rather than eliminating the tax and thereby gain some more revenue. The answer is no. In our business, if we are wrong by five hundredths of 1 percent in the interest rate, the issue fails and we own it. In the nature of things, any tax that would be significant in terms of net revenue after administrative costs would also be a significant deterrent.

You have heard testimony describing what the U.S. bond market would have been like in 1982 if some U.S. corporations had not had access to foreign bond buyers through the Netherlands Antilles. It would have been painful. We are advocating that access to those investors be broadened and made available to the Treasury in its longer term financings. H.R. 3025 would do that, with a revenue bonus thrown in, and we urge its prompt passage.

Thank you.

[The prepared statement of Mr. Evans follows:]

STATEMENT OF JOHN C. EVANS OF MORGAN STANLEY & CO., INC.

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First, while I understand that the Treasury must be conservative in its own estimates of the revenue consequences, I should point out that there is apparently no way to get the figure for taxes actually collected that would be eliminated by this Bill. It was necessary therefore, to start with the total tax collected and deduct certain amounts which could be identified that would not be eliminated by the Bill. There was no way to identify tax collected on bank loans, which would not be eliminated by the Bill. Also, I do not believe that tax paid on the Treasury's own so-called "Carter bonds" (which tax the Treasury added to the interest rate and in effect pays to itself) has been deducted. In trying to get at the revenue gain that would result from this bill, we have tried to identify some types of foreigners who would have bought U.S. domestic bonds and paid the tax, which tax would therefore have to be deducted from the revenue gain resulting from the elimination of foreign tax credits by the Gibbons-Conable Bill. None of the five leading firms in our industry, which together accounted for almost 70 percent of all new corporate bonds issued in the U.S. in 1982, and who also, taken together, represent a majority of secondary market trading, has been able to identify such a foreigner. That is not suprising because such a person would have to seem to act irrationally. Who would buy a domestic G.M.A.C. bond and pay a 30 percent tax when there are plenty of tax free G.M.A.C. bonds (more than $2 billion) outstanding in the offshore Eurobond market? The bottom line is that we think the actual net revenue gain is likely to be nearer to twice the Treasury's conservative estimate. We have seen no evidence to date that has caused us to change our own estimate.

The bill which imposed the 30 percent withholding tax on foreign investors was enacted many years ago and for decades the impact was negligible since the Euromarket and foreign investors' appetites were extremely limited. Now as will be shown this is a very important potential source of investment in our government and corporate securities and this tax acts as a virtual barrier to this investment.

Secondly, as the Treasury can attest, the Gibbons-Conable Bill will enable it to know more about where the interest payments are going and will empower the Treasury to reimpose the tax (which functions as a virtually 100 percent effective protective tariff) on those countries which do not satisfy the Treasury that they are not parties to evasion by U.S. taxpayers. One bad bank, in other words, can put all other banks in the same country, and their clients, out of the U.S. domestic bond business. The pressures for self policing are evident.

Thirdly, it is our opinion that the principal beneficiaries of foreign capital that would be permitted into the U.S. by Gibbons-Conable would be U.S. Treasury Notes and Bonds. These incremental funds would not only assist in financing our deficits but, coming at the margin, would tend to lower the Treasury's long-term borrowing costs. The latter, I would submit, has the same effect as a revenue gain.

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The Eurobond market is truly an international market. Although the actual work of preparing and placing new bond issues in this market is centered in Europe (hence the name) the market itself has no nationality. It is virtually worldwide as to issuers and investors. While it used to be a pale shadow of our own vaunted domestic corporate bond market, it has grown rapidly in recent years. In 1982 the U.S. dollar denominated sector of this offshore market, believe it or not, reached the same size in new issue volume as our own bond market. And only about 60 percent of the Eurobonds issued in 1982 were denominated in U.S. dollars; so the entire Eurobond new-issue market in 1982 was substantially larger than our own domestic bond market. My own firm, which is a leading manager and trader of issues in both markets, now has more people in our London office than we had in the whole firm 15 years ago, and very few of our London people are Americans. We have been forced to export jobs to remain competitive.

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Thank you.

Mr. **Gibbons**. Mr. Rey.

Mr. **Rey**. Mr. Chairman, I am Nicholas Rey, managing director of Merrill Lynch White Weld Capital Markets. I just would like to supplement what our two previous speakers have said with two points.

First is that H.R. 3025 can be viewed as a small business bill. Under current conditions, when U.S. borrowers wish to borrow abroad, and they have to do so through Netherlands Antilles subsidiaries. This is a rather sophisticated process requiring major corporations with banks of lawyers, et cetera. With H.R. 3025, and the removal of the 30-percent withholding tax, it will be infinitely easier for all Americans, whether small companies, large companies or in fact the Federal Government itself, to borrow directly from foreigners. This is point 1.

Point 2 is that by removing the tax we will open up the broad U.S. long-term bond markets to foreign investors for the first time, the secondary markets as well as the new issue markets. And this should tend to some degree at least to assist in lowering long-term interest rates in the United States.

Thank you very much, Mr. Chairman.

Mr. **Gibbons**. Thank you.

Mr. Grand-Jean.

Mr. **Grand-Jean**. The only point that our firm would like to make is that at a time when Chairman Volcker and Members of both Houses of Congress, both parties, Secretary of the Treasury and public officials of all types are pointing out the hazards of the very large Federal budget to our entire way of life, H.R. 3025 bill is a bill which not only produces some revenue for the Treasury, but would ease the burden on the U.S. capital markets. It would make it possible not only for the U.S. Treasury to borrow directly, but also for the U.S. companies which risk being squeezed out of the market by the Treasury to borrow abroad in a far simpler and more direct fashion than they do today.

Mr. **Gibbons**. Thank you.

Mr. Fisher, your testimony is in a little different area. Let's go to questions with this group of gentlemen right now.

Mr. Conable.

Mr. **Conable**. I would like to ask you, what would be the attitude of foreign countries to this? We are getting an awful lot of flak about high interest rate policies in the United States to facilitate the flow of capital into this country. It has been a saving grace for us with our terrible trade balance to have current accounts somewhat corrected by the massive investment in this country. I should think that foreign countries would be very resistant to the idea of our facilitating that flow of capital at this point. Most of them consider themselves denuded by our policies now.

Even though they are inward looking, they assume we do what we do in order to get their capital away from them, and we are pursuing a high interest policy for our own interest here. I think the official reaction would be rather resistant, wouldn't it?

Mr. **Rey**. You may be right. However, they would have a problem here. Because just about every major country in the world exempts their issuers in the international markets from their own withholding tax, they would find it rather difficult to argue too strenuously on this point.

Mr. **Conable**. Being in a glass house they wouldn't be able to throw too many stones.

Mr. **Rey**. Exactly. Second, these are dollars already. We are not talking about the shifting from foreign currencies into the United States to any great extent. We are talking more about dollars that already exist in the international markets, in the international bond markets, coming here rather than being invested in the Eurobond market. And to the extent that helps to lower interest rates in the United States, I think we have a very good counter argument to any arguments that the foreigners might be willing to make against us.

Mr. **Conable**. Thank you.

Mr. **Evans**. Mr. Conable, I would only add—this is hearsay, since I asked the Treasury the same question, and they said that the European countries are not really concerned about this issue. A lot of this money is already out in the Euromarkets. I anticipate the Netherlands Antilles would not——

Mr. **Gibbons**. Yes; I can understand the monopoly they have—that sort of motivates any action they would take.

As I see it, Barber, it might have a very healthy effect upon their economies, too. It would tend to raise interest rates in their markets, while it would lower interest rates in our markets. I don't know how much that would be, but it would then take some of the artificial inflation out of the dollar. Or would it? This is an area——

Mr. **Evans**. I think we have to recognize that we are talking about long-term investments here.

Mr. **Gibbons**. Yes.

Mr. **Evans**. As I said, I believe the money that flows in huge amounts one way and then the other in anticipation of exchange rate changes or whatever tends to go into the shorter term instruments which are already exempt from the tax.

I myself would not expect to see any significant selling of domestic bonds in foreign countries in order to come into this. I don't know that there are any other views on the panel. I would expect to see some selling of Eurobonds to come into this.

Mr. **Loverd**. I think that you are absolutely correct, that, on the margin, H.R. 3025 would tend to have lower interest rates here, and would tend to raise higher interest rates in other capital markets. But I think that given the size of the world's financial markets, it is extremely difficult to arrive at a conclusion that those changes would be significant in long-term markets, and that the changes in currency values, as money moved from one market to another, would be significant in light of the billions or trillions of dollars of trade and short-term investment that take place around the world through currency markets.

Mr. **Gibbons**. Well, I have studied this thing for some time, and I know I am just a novice. So please excuse my flubbing around in this area. But I think in summary you can say of this bill that, one, it certainly would at least increase the revenues of the United States by at least $80 million a year, and you believe more than that. And two, it would help the United States meet its capital requirements at a time when we really need all the help we can get to our capital requirements.

To that extent it would not be an inflationary factor at all, perhaps a deflationary factor. And it would certainly help in some way keeping down these rates. It would be one of the contributing factors of keeping down the rates. I don't want to overstate the impact of our bill, but am I reasonably accurate?

Mr. **Evans.** I believe the Treasury's estimate of the revenue gain was $35 to $50 million which they acknowledge is conservative.

Mr. **Rey.** Some of us think, however, Mr. Chairman, you may be closer to the truth.

Mr. **Evans.** You are right in the middle of our range.

Mr. **Gibbons.** Mr. Jacobs.

Mr. **Jacobs.** Gentlemen, this bill—we have spoken about it before—I am persuaded too that it is probably in the best interests of the country generally, which is what we are here for. If it raises $80 million—these hearings, as I read the notice, are for revenue-increasing measures. So you have put a toenail onto the subject.

The administration has proposed a budget that involves spending about $200 billion more than the administration says it wants to tax. It strikes me offhand as a bit of a problem.

Now, if we pass your bill, as I see it, we have about $199,920,000,000 to go. And this is a hearing about raising revenues. How would you raise the other $199,920,000,000?

Mr. **Evans.** I think there is no doubt that in the absence of diminishing expenditures, our problems are just going to get worse. The outyear deficits are worrying the bond markets. I am speaking personally now, not on behalf of the SIA and not on behalf of anyone else. I observe that our prices for gasoline in this country are very low by world standards, and that foreigners drive a lot in their cars. I think we could see some revenue from that source, and get ourselves better prepared for the next oil shock.

Mr. **Jacobs.** What do you expect we could raise that way a year?

Mr. **Evans.** Well, Mr. Brophy was here this morning, and—of course, it depends on how many cents per gallon you put on, whatever you had in mind.

I don't think that 50-cent tax he talked about is going to put us in the category with the Europeans on gasoline prices.

Mr. **Jacobs.** I know there is a study that says—

Mr. **Evans.** I believe he said 50 cents, did he not?

Mr. **Jacobs.** That was John Anderson's idea.

Now, we are down to $140 billion short, if we put 50 cents on gasoline.

Mr. **Evans.** I am not suggesting putting that tax on gasoline would be very easy.

Mr. **Jacobs.** Thank you very much.

Mr. **Gibbons.** We appreciate your coming. We know you have had a long wait. Hopefully, we can get this bill up and get it passed one of these days soon.

Could any of you tell us—I am not old enough to remember, and not that much of an expert to remember—how did we get ourselves in this Netherlands Antilles?

Mr. **Aidinoff.** I think I can answer that. When it was necessary to put on the interest equalization tax, it became essential for U.S. companies to borrow overseas to meet the requirements that were set by our foreign direct investment regulations. And because our internal law was not very flexible at that time, lawyers working with the Treasury Department realized that by going through the Netherlands Antiles, U.S. companies could in fact borrow free from withholding tax.

From 1965 through 1974, we had substantial borrowings by U.S. companies using the Netherlands Antilles route. If you recall, toward the end of the interest equalization period, Congress passed 4912(c) of the code and 861(a)(1)(g) of the code which in effect gave us a very limited period where all you had to do was in effect stamp a bond, say it was subject to the interest equalization tax, and interest withholding could be avoided.

If my recollection is correct, Congressman Conable was the cosponsor of that act with our then-Congressman Carey. And that is basically how the Netherlands Antilles route began to be used by U.S. companies to meet their obligations under the foreign direct investment regulations.

Mr. **Gibbons.** Thank you very much for coming.

STATEMENT OF LAWRENCE N. FISHER, CHAIRMAN, TAX COMMITTEE, NATIONAL CONSTRUCTORS ASSOCIATION AND SENIOR TAX COUNSEL, FLUOR CORP.

Mr. **Gibbons.** Mr. Fisher.

Mr. **Fisher.** Thank you very much, Mr. Chairman.

My name is Larry Fisher. I am chairman of the National Constructors Association Tax Committee. The NCA is a group that represents approximately 50 of the country's foremost international contractors.

We appreciate very much the opportunity to be able to participate in these hearings today.

We are here to urge your support of H.R. 1609. This bill, which is sponsored by Congressmen Gibbons, Frenzel, Conable, Archer, Hance, Vander Jagt, Thomas, and Campbell, we believe, will increase U.S. tax revenues by approximately $100 million per year, by removing current double tax trade barriers that effectively prevent U.S.-based construction firms from doing business in many areas of the world.

An identical bill, S. 1550, has been introduced in the Senate by Senators Chafee and Symms.

The double taxation addressed by the bill occurs because of an unintended aberration in the source-of-income rules that apply to the needed home office technical services that must be provided for any foreign construction project. An increasing number of foreign countries tax these out-of-country services on the basis that they represent technical assistance that is used in and paid for in their country.

The United States also taxes these services since they are performed here.

No tax credit relief is generally available on the U.S. side since the income is U.S. source. These technical assistance taxes are usually imposed on gross, rather than net, income at rates ranging from 5 to 40 percent.

In most cases, the tax exceeds the contractor's profit margin on the services.

The double tax places U.S.-based firms in an impossible position—absorb the double tax cost by bidding the project at a loss, or gross up the contract price to include the double tax costs, thereby making their bid noncompetitive.

With a 30-percent technical assistance tax, a client would have to be willing to pay $225 for every $100 worth of services. Obviously, this never happens in real life, and U.S. firms cannot get the work. The competitive disadvantage is made even more acute by the fact that the tax laws of our major trading partners already provide relief from this double tax burden.

At the present time, the only way for U.S. firms to avoid the double tax dilemma is to move the services from the United States to one of these other jurisdictions that already provides double tax relief.

Where the work is performed in this way, through a foreign subsidiary, then U.S. tax revenues on the services income and jobs are lost to the foreign country.

Furthermore, this method of coping with the double tax problem is not generally available to smaller firms who generally don't have offices outside the United States.

In this regard, we wish to point out that the Associated General Contractors, AGC, strongly support the bill and but for time limitations would have testified here today with us.

H.R. 1609 resolves the double taxation problem by allowing U.S. firms to claim a deduction for these technical assistance taxes as a cost of doing business. H.R. 1609 will increase U.S. tax revenues in the following ways: One, a substantial portion of the technical services now being performed through foreign subsidiaries will be returned to the United States.

Two, new work will be gained by U.S. firms due to being able to freely use their U.S. offices to perform projects in the technical assistance tax countries.

In summary, we believe H.R. 1609 is a realistic solution to a serious problem of international double taxation. We estimate that it will raise $100 million or more in additional tax revenues as a consequence of U.S. based firms being able to bid more competitively in the growing number of technical assistance tax countries.

It will create and retain U.S. jobs and encourage the inflow of capital to the United States.

We appreciate very much having this opportunity to present our views on this critical industry problem and I will be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF LAWRENCE N. FISHER, CHAIRMAN, TAX COMMITTEE, NATIONAL CONSTRUCTORS ASSOCIATION

Mr. Chairman and members of the committee, my name is Lawrence N. Fisher, and I am Chairman of the Tax Committee on the National Constructors Association ("NCA"). Our Association has represented many of America's large national construction companies for over 30 years. We presently have approximately 50 member companies, who are engaged in building major process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals production and fabricating; and other major process and manufacturing needs here in the United States and abroad.

H.R 1609, sponsored by Representatives Gibbons, Frenzel, Archer, Hance, Vander Jagt, Thomas, Campbell and Conable, addresses a critical problem of international double taxation which is currently preventing U.S. constructors from effectively competing for projects in many areas of the world. H.R. 1609 not only removes these double-taxation trade barriers, but does so in a way that will result in increased tax revenues to the U.S.

HOW DOUBLE TAXATION ARISES UNDER EXISTING LAW

Here is how this double-tax situation arises. A U.S. company wishes to bid on a contract to construct an industrial plant in an in-country construction activity, the company will be required to perform substantial design, engineering architectural, purchasing, construction mobilization, planning and other related technical services in its home office in the United States. The foreign country is one of many that impose a "technical assistance tax" on these U.S. services, on the grounds that the income from these services is "sourced" in the foreign country because the work is ultimately used there and paid for there.[1] However, the United States also taxes these services because the contractor is a U.S. company. Moreover, U.S. tax law considers the source of the income derived from this work to be the United States, where the work is performed.

In general, under U.S. rules, international double taxation on income from foreign activities is avoided by permitting a credit against U.S. taxes for the foreign taxes paid. The credit, however, may generally only be used to offset the U.S. tax payable on foreign-source income. Because technical assistance taxes are imposed on what the United States considers to be U.S.-source income, the payment of the technical assistance tax cannot practically be used as a credit against the U.S. tax due on that income.

Moreover, the tax may not be claimed as a deductible cost of doing business, since the taxpayer must elect to either credit or deduct all foreign taxes. Except in rare and extraordinary circumstances, economic compel U.S. taxpayers to elect to credit foreign income taxes. If the contractor elected to deduct foreign technical assistance taxes, all foreign income taxes including nomal foreign income taxes on net income from construction site services within the foreign country, would have to be deducted.

Thus, even though technical assistance taxes are considered foreign "income taxes" under U.S. law,[2] U.S. construction firms have no practical relief from international double taxation in many instances.

U.S. engineering and construction firms usually make less than a 10 percent pretax margin on gross billings. Foreign technical assistance taxes are usually in the range of 10–30 percent of billings. Thus, a U.S. firm cannot absorb the tax since it would be left with a substantial loss of the project. This barrier to U.S. competition abroad is illustrated as follows:

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[1] A significant number of foreign countries now tax income from services performed outside of their country, if the services relate to the construction project located within their country. Such countries include Argentina, Brazil, Chile, China, Colombia, Ecuador, Korea, Malaysia, Mexico, New Zealand, South Africa, Panama, Spain, Tanzania, Thailand, and Venezuela. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country.

[2] The foreign statutes imposing these taxes usually refer to taxes on payments for royalties but royalities are defined to include payments for know-how, technical and scientific information, etc., and other technical assistance. Such statutes are often interpreted broadly to include standard construction engineering services.

Technical assistance tax (30 percent)

Billings	$100
Costs	−90
Pre-tax income	10
T.A. tax (30 percent of 100)	−30
U.S. tax (46 percent of 10)	−4.6
Post-tax loss	−24.6

Moreover, if the U.S. firm increases ("grosses-up") its contract price to cover the double tax bill, then the U.S. firm will be immediately priced out of the market. With 30 percent technical assistance tax, a foreign client would have to be willing to pay $225 for $100 worth of services for a U.S. firm to get the job. Obviously, this never happens.

Technical assistance tax (30 percent)—hypothetical gross-up by client included

Billings	$100
Hypothetical gross-up	125
Costs	−90
Pre-tax income	135
T.A. tax (30 percent of 225)	−67.5
U.S. tax (46 percent of 135)	−62.1
Post-tax profit	5.4

THE TAX LAWS OF OUR MAJOR TRADING PARTNERS HAVE ALREADY SOLVED THIS PROBLEM

The international accounting firm of Arthur Young & Company recently conducted a survey of the treatment of foreign technical assistance taxes by the major trading partners of the United States. The survey makes clear that the home country jurisdictions of our principal competitors provide relief from the double taxation burdens that would otherwise result from such host country technical assistance taxes.

The survey came to the following conclusions:

"Briefly stated, it appears that, although many of our trading partners relieve double taxation through a foreign tax credit system similar to the one in the U.S., they avoid the double taxation of technical assistance described above by permitting either a deduction for foreign taxes paid on domestic source income (even if the taxpayer has elected to credit other foreign taxes against his income tax) or treating technical services as foreign source income, with a credit for the foreign taxes paid. In addition, certain of our trading partners provide incentives for companies performing this type of work. *This places U.S. corporations at a competitive disadvantage with our major trading partners' home country corporations.*" [Emphasis supplied.]

Thus, H.R. 1609 merely provides the same type of neutral tax regime for U.S. firms that is already available to their principal competitors. H.R. 1609 provides U.S. construction firms with a "level playing field" for international competition in the technical assistance tax countries.

HOW H.R. 1609 SOLVES THE PROBLEM

H.R. 1609 would allow a taxpayer generally electing to credit foreign taxes to elect to deduct the amount of any foreign income taxes imposed in connection with construction contract services rendered in the United States. The effect would be to treat foreign technical assistance taxes as an additional cost of doing business in the host country.

Under the bill, "construction contract" services are defined to mean engineering, architectural, design, project management procurement, cost estimating, scheduling, construction planning or construction mobilization services or other services which are related or subsidiary to any of the foregoing services. The definition is intended to be broad so that there will be no question that any of the services rendered in the United States related to the foreign project will constitute construction contract services.

Procedurally, the election to deduct foreign technical assistance taxes shall be made in the same manner and at the same time as is provided for the election to credit foreign taxes under section 901. Thus, no special procedural rules are required and the U.S. taxpayer can simply elect to deduct these taxes in situations in which it would otherwise receive neither a credit nor a deduction for the taxes.

H.R. 1609 also provides that if the foreign technical assistance taxes represent discriminatory taxation by a foreign country of American firms, the election shall not be allowed. This provision is intended to deter any foreign country from taking advantage of the ability of the American firm to receive a tax deduction in the United States for the payment. The discrimination provision would not be invoked if concessions with respect to the technical assistance tax are made under a double taxation convention. Differences in tax rate due to treaty provisions would not constitute discrimination since it is consistent with the U.S. policy of generally supporting bilateral tax concessions by treaty. Further, the U.S. may by treaty seek to negotiate mutually consistent treatment with some foreign countries imposing technical assistance taxes.

HOW H.R. 1609 WILL RESULT IN REVENUE GAINS TO THE U.S.

The only method presently available to cope with the double taxation situation is to render the services outside the U.S. Many of the larger U.S. firms doing business abroad have offices outside the U.S. If the technical assistance services are performed through a foreign subsidiary in one of the many countries that have solved the double taxation problem, then the necessity for a double taxation gross-up is avoided. This solution, which is now used frequently, involves a significant revenue loss to the U.S. because primary taxing jurisdiction is shifted to the country where the office is located. Because these countries all have relatively high rates that equal or exceed those of the U.S., the credit mechanism will eliminate any U.S. tax on dividend distributions and the U.S. will lose virtually all of its potential tax revenues from the project.

However, there are many smaller construction firms doing business abroad. These smaller firms are very unlikely to have overseas offices. Thus, this method of coping with the problem is not available to them. H.R. 1609 will permit U.S. firms to avoid this solution and will eliminate a current disparity between small and larger firms.

H.R. 1609 will thus increase U.S. taxable activity in two ways: (1) Technical services and related economic activity (e.g., procurement of materials) which are now carried on through foreign subsidiaries in order to minimize international double taxation could be moved into the U.S. and made subject to U.S. tax; and (2) U.S. firms could more effectively bid through their U.S. offices for additional overseas construction projects, and the necessary technical services for such projects would be performed in the U.S. Let's examine each of these two components a little more closely.

(1) Work moved to U.S. from foreign subsidiaries.—We have estimated this component of the revenue gain on the basis of current levels of overseas contract activity. The total value of foreign construction awards to U.S. construction firms in the year following enactment can be conservatively estimated at $50 billion, based on the fact that total awards in 1981, were $48.8 billion (Engineering News Record, Apr. 22, 1982).

The next step is to estimate the amount of awards that would be in countries imposing technical assistance taxes. While an exact projection is not possible, since foreign tax laws are continually in the process of change, the growing number of these taxes makes a low but reasonable estimate of about 25 percent, or $12.5 billion.

Of the latter amount, it can be estimated based on experience that roughly 20 percent, or $2.5 billion, involves technical assistance services and related economic activities, (e.g., procurement of materials) which can be performed outside the host country, either in the U.S. or in a foreign country where the U.S.-based firm has a subsidiary.

Next, it is estimated that about 50 percent of the latter contract activity, performed outside the host country, is now performed in the U.S. in all events. This activity involves U.S. companies which are able to take a foreign tax credit for the technical assistance taxes paid. These companies are often members of U.S. consolidated groups which include non-construction businesses such as equipment sales which can generate low-taxed foreign source income, thereby allowing utilization of the foreign taxes imposed on the U.S. construction services. It is important to understand that since a credit against tax is always more valuable than a deduction, these companies would not elect the deduction permitted by H.R. 1609 and there would be no revenue impact from the bill with respect to their activities.

However, to avoid double taxation, the other 50 percent of existing projects are now performed through foreign subsidiaries of U.S. construction firms to utilize the more favorable foreign tax law. Under existing law, the projects attributable to these affiliated companies are now not taxed by the U.S. This 50 percent represents about $1.25 billion of gross revenues now lost to the U.S.

The profit margin on these U.S. revenues can be estimated at about 10 percent, which would produce $125 million in taxable income. Thus, if the law is changed to allow this work to be done in the U.S, the U.S. revenue gain is 46 percent of $125 million, or about $57.5 million.

(2) Additional projects successfully bid by U.S. firms.—Further, if H.R. 1609 is enacted, it is reasonable to expect that U.S. companies can obtain additional overseas construction awards, which they cannot obtain through foreign subsidiaries, as a result of being able to freely perform the work directly through their main U.S. offices. U.S. home office facilities and employees are generally more efficient and productive than foreign subsidiary offices. As a consequence, the amount of home office services performed in the U.S. would be further increased. Thus, it is likely that the total U.S. revenue gain would exceed the $57.5 million estimated for the first component. If awards increase by only as little as $5 to $10 billion, U.S. gross revenues would increase by $1 to $2 billion (20 percent), U.S. profits by $100 to $200 million (10 percent), and U.S. tax revenues by about 46 percent to $92 million (46 percent).

SUMMARY OF U.S. REVENUE GAIN

The estimates made above can be summarized as follows:

(1) Total annual value of foreign construction awards to U.S. companies (billion)	$50
(2) Portion of (1) attributable to countries that impose technical assistance tax (25 percent) (billion)	12.5
(3) Portion of (2) to be performed outside the host country (20 percent) (billion)	2.5
(4) Portion of (3) which could be moved to U.S. (50 percent) (billion)	1.25
(5) U.S. profit margin on (4) (10 percent) (million)	125
(6) Annual revenue gain on existing levels of awards (46 percent of (5)) (million)	57.5
(7) Annual revenue gain from increased awards (million or more)	46
(8) Total annual U.S. revenue gain (million or more)	100

The foregoing estimates relate solely to the increase in corporate taxes to be paid directly by the U.S. firms performing technical services. Additional revenue gains would be derived from taxes imposed on the employees of the U.S. construction firms and on the U.S. vendors of construction materials and equipment and on the employees of these U.S. vendors. Absent H.R. 1609, these taxes are now being paid to foreign governments, not to the U.S. Treasury.

CONCLUSION

H.R. 1609 solves a very serious double taxation problem in an equitable and realistic manner. It will not only raise Federal tax revenues by allowing U.S. firms to freely do the work in the U.S. on foreign projects, but also will help create and retain jobs here rather than abroad and will aid the U.S. balance of trade by encouraging the inflow of capital.

An identical bill, S. 1550, has been introduced by Senators Chaffe and Symms of the Senate Finance Committee. We urge prompt passage of this much needed legislation.

Mr. GIBBONS. Mr. Fisher, I appreciate your coming and taking all this time and waiting all this long, long time to be heard.

You have made a fine statement and I am glad it is in support of this legislation.

Is this a problem that the United States could cure by tax treaties?

Mr. FISHER. Well, I have a couple observations on that.

First, we are dealing basically with countries with which we don't have existing treaties. We are dealing with a large number of countries, the Far East, South America, and I think as a practical matter to think that the problem could be accommodated through the treaty system would be a little unrealistic.

Mr. GIBBONS. Do we have problems with those countries with which we have tax treaties?

Mr. Fisher. No, generally not.

Mr. Gibbons. Because we have that definition of what is double taxation and it doesn't become a problem, is that it?

Mr. Fisher. Correct.

Mr. Gibbons. Or is it because we are just not competitive enough?

Mr. Fisher. No, it is more because with the PE concept and with the treaty you have a clear demarcation of tax jurisdiction rules.

Mr. Gibbons. To your knowledge has Treasury attempted to get tax treaties with these other countries?

Mr. Fisher. I do not believe that any of these countries—maybe there are one or two—generally speaking they are not countries where we are actively involved in the treaty process.

Mr. Gibbons. Mr. Conable.

Mr. Conable. I don't have any questions.

Thank you. I think you have made good points.

Mr. Gibbons. Mr. Jacobs.

Mr. Jacobs. Thank you very much.

Mr. Gibbons. I cannot really emphasize sufficiently, what attracted me was the fact it produced jobs here in America.

Mr. Conable. Who started this?

Mr. Gibbons. Bill and I have introduced it.

One, it produces jobs in America, and two, it means we will sell more goods overseas because our engineers will be doing the work and our constructors will be doing the work.

Mr. Fisher. Correct.

Mr. Gibbons. And they will be designing the American components which is very important. That will mean not only original equipment but replacement parts and everything.

Mr. Fisher. Correct.

Mr. Gibbons. And three, our competitors have already other major industrial nations who have these provisions and we are not competitive as long as we don't have them.

Mr. Fisher. That is correct.

Mr. Gibbons. We just don't get the business. We are not competitive.

Mr. Fisher. Right.

Mr. Gibbons. In an effort to make America more competitive and to raise more revenue, I think we need to do this. I want you to know I vigorously support my bill.

Mr. Fisher. We appreciate your help.

Mr. Gibbons. Thank you, sir.

Our concluding witness today is Mr. Richard E. Morgan, research director for Environmental Action.

STATEMENT OF RICHARD E. MORGAN, RESEARCH COORDINATOR, ENVIRONMENTAL ACTION FOUNDATION

Mr. Morgan. Thank you, Mr. Chairman.

Mr. Gibbons. You are not only the concluding witness for today but you are the concluding witness for this set of hearings.

Mr. Conable. A great responsibility.

Mr. Morgan. I am sure you are all very tired so I will try to be brief.

Mr. Chairman, members of the House Ways and Means Committee, my name is Richard E. Morgan. I am research coordinator for the energy project of the Environmental Action Foundation. My business address is 724 Dupont Circle Building, Washington, D.C., 20036.

Today I am testifying on behalf of Envionmental Action, Inc., which is an affiliate of Environmental Action Foundation, and for 14 national and local organizations: Environmental Policy Center, Natural Resources Defense Council, Union of Concerned Scientists, Sierra Club, Critical Mass Energy Project, Solar Lobby, Nuclear Information and Research Service, Campaign for a Prosperous Georgia, Citizens Action Coalition of Indiana, Florida Consumers Federation, Illinois Public Action Council, Kansas Natural Resource Council, Labor Coalition on Public Utilities (Illinois), and Missouri Public Interest Research Group. I appreciate this opportunity to present the views of these organizations on Federal tax expenditures for electric utilities.

Federal tax expenditures for electric utilities are among the highest for major industrial sectors of our economy. This is due in part to the unique features of our Nation's electric power industry and in part to special treatment of utilities by the Internal Revenue Code. By analyzing U.S. Government figures, I have calculated that tax benefits provided to electric utilities cost the U.S. Treasury at least $9.7 billion annually.

Mr. **Gibbons**. You say $9.7 billion?

Mr. **Morgan**. $9.7 billion annually, that is correct.

Since private electric utilities made $31 billion in capital investments in 1982 (Source: Electrical World, March 1983, p. 64), this Federal tax subsidy represents 31 percent of all capital spending by private electric companies. The magnitude of these benefits to the power industry is even greater than this figure indicates due to the federally mandated accounting treatment for certain major tax benefits received by utilities.

Besides the loss of revenue to the U.S. Treasury, tax benefits to electric utilities have several undesirable effects upon our economy. These multi-billion-dollar incentives for new utility investments cause distortions in the market forces which should shape our society's investment decisions. These subsidies from the Federal Treasury result in the allocation of scarce capital to potentially wasteful and unnecessary investments in new power generating facilities.

Because of Federal tax benefits, approximately one-fourth of all power companies do not pay any Federal income tax in a given year, with most of these companies receiving tax refunds.

The entire power industry earned $17 billion in profits in 1981, but paid only $1.7 billion in taxes, according to DOE. This represents an effective tax rate of 10 percent in 1981, far lower than for most industrial sectors. Moreover, the Congressional Budget Office has predicted that under the current law, the Federal tax burden on electric utilities may be eliminated altogether by 1984 or 1985. (Source: Congressional Budget Office, "Promoting Efficiency in the Electric Utility Sector," Nov. 1982, p. 44.)

Tax benefits received by electric utilities have increased substantially in recent years. In 1954, electric utilities paid 12.7 percent of their gross revenues to the Federal Government as income taxes, according to the Federal Power Commission's "Statistics of Privately Owned Electric Utilities." By 1981, Federal income tax payments had dropped to less than 1.5 percent of gross revenues, according to DOE.

Let us briefly consider the major sources of tax benefits received by electric utilities.

INVESTMENT TAX CREDIT

Like all other businesses, private utilities receive a 10-percent Federal tax credit for investments in new machinery. Since virtually the entire expense of building a new powerplant qualifies for the ITC, a utility may subtract 10 percent of the plant cost from its tax liability.

Environmental Action Foundation estimates that the ITC's received by electric utilities cost the U.S. Treasury about $1.5 billion annually.

ACCELERATED DEPRECIATION AND SHORTENED TAX LIVES

Electric utilities derive substantial benefits from the provisions of the Internal Revenue Code which allow postponement of the tax payments through accelerated depreciation and shortened tax lives. While rapid depreciation is available to all businesses, the capital-intensive nature of electric utilities allows them to defer major portions of their income tax liability.

Although theoretically these deferred taxes should eventually be paid to the U.S. Treasury, Government figures indicate that utilities' deferred tax accounts are increasing in size and that utilities appear to be postponing some tax payments indefinitely. At the end of 1981, power companies were holding $16.7 billion in their deferred tax accounts and $8.4 billion in their deferred investment tax credit accounts, according to DOE. Thus, as of 1981, the power industry had accumulated over $25 billion in unpaid taxes. These deferred tax accounts are increasing by $3 to $4 billion each year.

DEPRECIATION BASIS ADJUSTMENT

Because the Federal Government subsidizes new utility investments through the ITC, many economists argue that a business should not be able to claim depreciation on the portion of the investment that was paid for by the Government. In 1982, Congress required that the depreciation base of assets be reduced by one-half of the value of the investment credit. Even with this "basis adjustment," a utility may depreciate 95 percent of the value of a new powerplant, although it paid for only 90 percent of the plant.

INTEREST EXPENSE DEDUCTION

The capital structure of the electric utility industry enables it to take greater advantage of interest expense deductions than other corporate sectors. While any business which raises capital by issuing bonds can deduct the interest paid on this long-term debt, utilities raise more than half of their external capital through long-term debt, compared to only 10 to 15 percent for most industries.

Utilities are thus uniquely able to deduct the costs of more than half of their long-term financing. The Foundation estimates that this provision of the Internal Revenue Code saved electric companies an estimated $5.3 billion in 1981. The extraordinary benefits which they receive from the interest deduction should be taken into account in evaluating the need for other tax benefits to utilities.

TAX EXEMPT POLLUTION CONTROL BONDS

Section 103 of the Internal Revenue Code allows private businesses to use tax-exempt bonds to finance investments in pollution control facilities. This provision is expected to cost the U.S. Treasury $975 million in 1983.

In 1982, electric utilities issued 88 separate pollution control bond offerings with a total volume of $3.4 billion, representing 58.4 percent of the dollar volume of such bonds issued in 1982. If the power industry's share of pollution control bond issues remains the same, the cost of this tax expenditure for electric utilities alone will be $569 million in 1983.

The effectiveness of this subsidy for pollution control investments is questionable since most such investments are required by environmental laws. Furthermore, utilities frequently use tax-exempt pollution control bonds as a major source of capital for financing new powerplant construction, which is not the purpose of the tax-exempt bonds. Some utilities have been able to use pollution control bonds to finance more than 30 percent of a projected investment in new generating facilities. Thus, rather than encouraging pollution control, this costly tax expenditure appears to subsidize investments by electric utilities.

DEDUCTION FOR PREFERRED STOCK DIVIDENDS

Even though utilities already receive disproportionately large benefits from basic provisions in the Tax Code such as accelerated depreciation and interest deductions, the code offers additional special provisions for utilities. One of these is a special deduction for utility preferred stock. Section 247 of the Internal Revenue Code allows utilities to deduct a portion of the cost of dividends paid on preferred stock from their taxable income. This unique provision was enacted in 1942 to aid wartime expansion of utility facilities. It has remained in law for 41 years, despite the apparent lack of any rationale in peacetime.

Corporate taxpayers which purchase qualifying utility preferred stock also receive a special tax deduction under section 244 of the Internal Revenue Code. Together, sections 244 and 247 cost the U.S. Treasury about $24 million annually for all utilities, as estimated by the Treasury.

DIVIDEND REINVESTMENT PROGRAM

As part of the Economic Recovery Tax Act of 1981, Congress provided another tax benefit intended just for utilities. The dividend reinvestment program allows certain utility stockholders to postpone payment of Federal income taxes associated with utility stock dividends, provided that these dividends are reinvested in new stock of that company. This provision helps utilities raise capital at a reduced cost, but entails a tax expenditure by the U.S. Treasury.

The Senate Finance Committee has estimated that this program will cost the U.S. Treasury $900 million for 1983–85.

Due to this unique combination of tax benefits, the current Federal tax expenditures for electric utilities amounts to $9.7 billion annually. The table below summarizes these expenditures.

Approximate annual Federal tax expenditures for electric utilities: Investment tax credit, $1.5 billion; accelerated depreciation and shortened tax lives, $2 billion; interest expense deductions, $5.3 billion; pollution control bonds, $0.6 billion; dividend reinvestment program, $0.3 billion; total, $9.7 billion.

BENEFITS FROM TAX NORMALIZATION

While the focus of the hearing today is on tax expenditures, the full benefit of the Tax Code for utilities goes beyond their reduced tax payments. Currently, sections 46(f) and 167(l) of the Internal Revenue Code require that utility tax benefits receive normalized accounting treatment. This requires utilities to charge their ratepayers for taxes as if no tax credits or deferrals had been received.

Consumers and many regulators prefer an accounting alternative known as flowthrough, whereby a utility passes its tax savings on to consumers without delay. This practice is not allowed by current Federal law.

A utility normalizes its ITC benefits from a new powerplant by charging its customers as if there were no tax credit. The deferred ITC's a utility collects from its customers are placed in a special account. This money is refunded to ratepayers over the life of the plant, a process taking approximately 40 years.

Savings from accelerated depreciation and shortened tax lives are normalized by a different method. When a utility receives a tax deferral for a new investment, it charges its customers as if there was no deferral. The taxes owed to the Government are placed in a deferred tax account and held there until they are paid to the Internal Revenue Service. If a utility continues making new investments, it can keep postponing a large portion of its tax liability indefinitely.

Deferred taxes and tax credits are available to the utility for investment in new powerplants.

In a report released last month by the Environmental Action Foundation, the Nation's 100 largest power companies were surveyed and tax overcharges amounting to $3.7 billion in 1981 were reported, chiefly as a result of the normalization requirement. These unpaid taxes have come to be known as phantom taxes, a term originating with former Federal Power Commission Chair Howard Morgan.

The survey found that the electric utilities studied had billed ratepayers for $5 billion in Federal income taxes in 1981, but reported paying only $1.3 billion to the IRS. Thus, for every dollar paid to the Government, the companies retained over $3.

For each of the 100 utilities which we surveyed, the tax overcharge and accumulated deferred tax amounts are listed in the table included as exhibit 1 of our testimony. The 10 highest ranking utilities in phantom tax charges and the 10 highest in the size of their accumulated deferred tax accounts are listed as exhibit 2.

ECONOMIC NORMALIZATION

Another provision contained in section 46(f) allows utilities to earn a hidden profit from the normalization of their tax credits. Under Federal law, utility ratepayers must provide capital for 10 percent of a new powerplant through the normalization of ITC's. Utility regulators generally favor a procedure called economic normalization, which requires that these deferred ITC's be deducted from the utility's rate base and also be refunded to ratepayers in later years.

Regulators generally use economic normalization to treat deferred taxes arising from accelerated depreciation and shortened tax lives, but Federal law prevents them from using economic normalization for ITC benefits. Thus, the law enables utilities to earn a profit on the portion of their investments that are financed by ratepayers through deferred tax credits.

Environmental Action Foundation has calculated that the extra profits that electric utilities earn from the ITC totaled $762 billion in 1981. We estimate that the sum will increase to about $3 billion annually by the 1990's.

THE NEED FOR UTILITY TAX BREAKS

Most of these tax subsidies for electric utilities were adopted at a time when the power companies were engaged in a large expansion program to meet a rapidly growing demand for electricity. Times have changed. The growth in power demands has been declining over the past 10 years and has now come to a virtual standstill.

The power industry current has a record 39 percent generating reserve margin. [Source: Edison Electric Institute] Excess generating capacity is costing consumers billions of dollars in higher electric bills, yet the Federal Government continues to offer the utilities billion-dollar incentives for investing in new powerplants.

These Federal tax benefits encourage inefficient management by the power companies. By providing a large pool of cost-free capital for powerplant construction, phantom taxes make the financing of new construction artificially inexpensive. Moreover, the perpetual postponement of taxes gives utilities an incentive to keep expanding and building new powerplants, to avoid paying their accumulated deferred taxes. Power companies often become locked into a growth cycle which is difficult to break out of.

CONCLUSION

The current network of Federal tax benefits to the electric utility industry is costly both to the Federal Treasury and to consumers. Further, it encourages inefficient utility management decisions to pursue expensive means of meeting future generating needs at a time when least-cost approaches should be vigorously pursued. During this period of mounting deficits, the Federal Government should not be offering almost $10 billion annually in investment incentives to companies which are already required by law to make the investment necessary to provide adequate service.

Environmental Action Foundation urges the Ways and Means Committee to consider the following changes in the Internal Revenue Code as it pertains to electric utilities: One, reduce or eliminate the ITC for electric utilities; two, equalize the tax lives for all generating plants at a minimum of 15 years, in order to eliminate the bias against coal plants in the current law; three, eliminate special preferences for utilities in the Tax Code, such as the deduction for preferred stock dividends and the dividend reinvestment provision; four, remove the full 10 percent ITC from the depreciation base; five, remove Federal restrictions on the ability of State utility commissions to determine the appropriate accounting procedures to be used for electric utility tax benefits.

These changes in the Tax Code could increase Federal revenues by between $2 billion and $4 billion annually. At the same time the impact on ratepayers can be mitigated by removing the Federal restriction on the flowthrough of tax benefits to ratepayers.

Thank you for this opportunity to share with you our views on the tax treatment of electric utilities and on the potential for providing additional revenues for the Treasury by giving less preferential treatment to electric utilities.

[The prepared statement follows:]

Statement of Richard E. Morgan, Research Director, Environmental Action Foundation, on Behalf of Environmental Action, Inc., Environmental Policy Center, Natural Resources Defense Council, Union of Concerned Scientists, Sierra Club, Critical Mass Energy Project, Solar Lobby, Nuclear Information and Resource Service, Campaign for a Prosperous Georgia, Florida Consumers Federation, Missouri Public Interest Research Group, Kansas Natural Resource Council, Illinois Public Action Council, Labor Coalition on Public Utilities (Illinois), and Citizens Action Coalition of Indiana

SUMMARY

Due to the unique features of our nation's electric power industry and to special treatment of utilities by the Internal Revenue Code, federal tax expenditures for electric utilities are among the highest for major industrial sectors of our economy. Preliminary calculations show that tax expenditures for electric utilities total $9.7 billion annually. The magnitude of these benefits is even greater than this figure indicates due to the federally mandated accounting treatment for major tax benefits received by utilities.

Estimated annual tax expenditures

	Billions
Investment tax credit	$1.5
Accelerated depreciation and shortened tax lives	2.0
Interest expense deductions	5.3
Pollution control bonds	.6
Dividend reinvestment program	.3
Total	9.7

This does not include tax expenditures arising from the lack of full depreciation basis adjustment for the ITC.

An assessment of the full benefit of the tax code for electric utilities must include the requirement that utility tax benefits receive normalized accounting treatment. Environmental Action Foundation has recently completed a report on the 100 largest electric utilities which shows that ratepayers were billed for $5 billion in federal income taxes in 1981, but that the utilities reported paying only $1.3 billion to the Internal Revenue Service. Thus, electric utilities increased their earnings by $3.7 billion as a result of the federal normalizaton provision.

The current network of federal tax benefits to the electric utility industry is costly both to the federal and to consumers. The following changes in the Internal Revenue Code as it pertains to electric utilities are recommended:

(1) Reduce or eliminate the ITC;

(2) Equalize the tax lives for all generating plants at the minimum of 15 years, in order to eliminate the bias against coal plants in current law;

(3) Eliminate special preferences for utilities in the tax code, such as the deduction for preferred stock dividends and the dividend reinvestment provision;

(4) Remove the full 10 percent ITC from the depreciation base; and

(5) Remove federal restrictions on the ability of state utility commissions to determine the appropriate accounting procedures to be used for electric utility tax benefits.

STATEMENT

Mr. Chairman and members of the House Ways and Means Committee, my name is Richard E. Morgan. I am Research Coordinator for the Energy Project of the Environment Action Foundation. My business address is 724 Dupont Circle Building, Washington, D.C. 20036.

Today I am testifying on behalf of Environmental Action, Inc., which is an affiliate of Environmental Action Foundation, and for 14 national and local organizations; Environmental Policy Center, Natural Resources Defense Council, Union of Concerned Scientists, Sierra Club, Critical Mass Energy Project, Solar Lobby, Nuclear Information and Resource Service, Campaign for a Prosperous Georgia, Citizens Action Coalition of Indiana, Florida Consumers Federation, Illinois Public Action Council, Kansas Natural Resource Council, Labor Coalition on Public Utilities (Illinois), and Missouri Public Interest Research Group. I appreciate this opportunity to present the views of these organizations on federal tax expenditures for electric utilities.

Federal tax expenditures for electric utilities are among the highest for major industrial sectors of our economy. This is due in part to the unique features of our nation's electric power industry and in part to special treatment of utilities by the Intenal Revenue Code. By analyzing U.S. government figures, I have calculated that tax benefits provided to electric utilities cost the U.S. Treasury at least $9.7 billion annually. Since private electric utilities made $31 billion in capital investments in 1982 (Source: Electrical World, March 1983, p. 1983, p. 64), this federal tax subsidy represents 31 percent of all capital spending by private electric companies. The magnitude of these benefits to the power industry is even greater than this figure indicates due to the federally mandated accounting treatment for certain major tax benefits received by utilities.

Besides the loss of revenue to the U.S. Treasury, tax benefits to electric utilities have several undesirable effects upon our economy. These multi-billion-dollar incentives for new utility investment causes distortions in the market forces which should shape our society's investment decisions. These subsidies from the federal treasury result in thie allocation of scarce capital to potentially wasteful and unnecessary investments in new power generating facilities. Furthermore, these incentives for long-term utility investments introduce a bias against energy conservation and short lead-time solutions to meeting consumers' energy needs which are often less expensive than power plant construction.

Because of federal tax benefits, approximately one fourth of all power companies do not pay any federal income tax in a given year, with most of these companies receiving tax refunds. In 1981, for instance, 43 of the 204 private electric utilities reported paying no federal income tax on their utility business. (Source: U.S. Dept. of Energy, Statistics of Privately Owned Electric Utilities in U.S., 1981 Annual)

The entire power industry earned $17 billion in profits in 1981, but paid only $1.7 billion in taxes, according to DOE. This represents an effective tax rate of 10 percent in 1981, far lower than for most industrial sectors. By comparison, the Joint Committee on Taxation reports 1981 effective tax rates of 48 percent for motor vehicles; 46 percent for trucking; 36 percent for pharmaceuticals; 31 percent for tobacco; 30 percent for diversified services; 29 percent for electronics, appliances and beverages; 27 percent for food processors; 25 percent for office equipment; 24 percent for industrial and farm equipment; 23 percent for retailing; 17 percent for diversified financial; and 16 percent for airlines.

Tax benefits received by electric utilities have increased substantially in recent years. In 1954, electric utilities paid 12.7 percent of their gross revenues to the federal government as income taxes, according to the Federal Power Commission's

"Statistics of Privately Owned Electric Utilities." By 1981, federal income tax payments had dropped to less than 1.5 percent of gross revenues, according to DOE.

Let us briefly consider the major sources of tax benefits received by electric utilities.

Investment tax credit

Like all other businesses, private utilities receive a 10 percent federal tax credit for investments in new machinery. Since virtually the entire expense of building a new power plant qualifies for the ITC, a utility may subtract 10 percent of the plant cost from its tax liability.

To illustrate the magnitude of this tax benefit, let us consider recent data on the cost of the 49 nuclear units currently under construction, compiled by Salomon Brothers Inc. (Mark D. Luftig and Mo Ying Wong, "Electric Utility Quality Measurements—Quarterly Review", April 12, 1983. In mixed current dollars, the average cost per kilowatt is $2,264 which, for the average 1000 megawatt plant, reflects a $2.3 billion investment. This creates a tax expenditure of $230 million per average nuclear unit. Turning to the aggregate cost of $121 billion for nuclear units under construction, the Environmental Action Foundation has concluded that federal ITC tax expenditures of $12.1 billion will be required for the current utility nuclear construction program. While the Foundation does not at present have comparable figures for the coal units under construction, we can state generally that tax expenditures will be substantial. Although coal units have a lower capital cost, 93 new units are currently under construction with a total capacity of 54,712 megawatts.

Environmental Action Foundation estimates that the ITC's received by electric utilities cost the U.S. Treasury about $1.5 billion annually.

Accelerated depreciation and shortened tax lives

Electric utilities derive substantial benefits from the provisions of the Internal Revenue Code which allow postponement of tax payments through accelerated depreciation and shortened tax lives. While rapid depreciation is available to all businesses, the capital-intensive nature of electric utilities allows them to defer major portions of their income tax liability.

The Accelerated Cost Recovery System adopted in the Economic Recovery Tax Act of 1981 includes shortened tax life provisions which are very generous to utilities. Under the law, a 30-year investment in a coal plant can be depreciated in 15 years. Nuclear plants receive even more favorable treatment with a tax life of just 10 years. We are not aware of any specific justification for this difference in tax lives in the legislative history. thus there appears to be an arbitrary federal preference for one form of technology over another.

In 1981, depreciation provisions for all federal and state income taxes enabled the electric utilities to defer approximately $4.7 billion in income taxes, according to DOE. In the same year, these companies paid only $2.5 billion in deferred income taxes from prior years. Thus, net tax deferrals allowed electric utilities to avoid $2.2 billion in income taxes in 1981. After factoring out deferrals of state income tax, the cost to the U.S. Ttreasury was about $2.0 billion in 1981.

The tax deferral figures for 1981 are hadly unique. Net deferrals of federal and state income taxes in preceding years amounted to $2 billion in 1980; $1.9 billion in 1979; $1.6 billion in 1978; and $1.5 billion in 1977. Thus while there have been substantial tax expenditures each year, there has been a trend of increasing cost to the U.S. Treasury.

Although theoretically these deferred taxes should eventually be paid to the U.S. Treasury, government figures indicate that utilities' deferred tax accounts are increasing in size and that utilities appear to be postponing some tax payments indefinitely. At the end of 1981, power companies were holding $16.7 billion in their deferred tax accounts and $8.4 billion in their deferred investment tax credit accounts, according to DOE. Thus, as of 1981, the power industry had accumulated over $25 billion in unpaid taxes. These deferred tax accounts are increasing by $3–$4 billion each year.

Depreciation basis adjustment

Because the federal government subsidizes new utility investments through the ITC, many economists argue that a business should not be able to claim depreciation on the portion of the investment that was paid for by the government. In 1982, Congress required that the depreciation base of assets be reduced by one-half of the value of the investment credit. Even with this "basis adjustment," a utility may depreciate 95 percent of the value of a new power plant, although it paid for only 90 percent of the plant. (Internal Revenue Code, Sections 48 and 196) We have not determined the cost of this tax expenditure, so it would be in addition to the $9.7 billion annually we have estimated for other federal tax subsidies for electric utilities.

Interest expense deduction

The capital structure of the electric utility industry enables it to take greater advantage of interest expense deductions than other corporate sectors. While any business which raises capital by issuing bonds can deduct the interest paid on this long-term debt, utilities raise more than half of their external capital through long-term debt, compared to only 10–15 percent for most industries. (Source: Christopher P. Davis, "Federal Tax Subsidies for Electric Utilities: An Energy Policy Perspective," Harvard Environmental law Review, 4:2, 1980.) Utilities are thus uniquely able to deducts the costs of more than half of their long-term financing. The Foundation estimates that this provision of the Internal Revenue Code saved electric companies an estimated $5.3 billion in 1981. The extraordinary benefits which they receive from the interest deduction should be taken into account in evaluating the need for other tax benefits to utilities.

Tax exempt pollution control bonds

Section 103 of the Internal Revenue Code allows private businesses to use tax-exempt bonds to finance investments in pollution control facilities. This provision is expected to cost the U.S. Treasury $975 million in 1983. (Source: U.S. Office of Management and Budget, Special Analysis G, Budget of the U.S. Government, fiscal year 1984, January 1983, Table G–2, p. G–31.) In 1982, electric utilities issued 88 separate pollution control bond offerings with a total volume of $3.4 billion, representing 58.4 percent of the dollar volume of such bonds issued in 1982. (Source: "Tax-Exempt Industrial Pollution Control Financing," in The Weekly Bond Buyer, March 28, 1983, with calculations by Environmental Action Foundation.) If the power industry's share of pollution control bond issues remains the same, the cost of this tax expenditure for electric utilities alone will be $569 million in 1983.

The effectiveness of this subsidy for pollution control investments is questionable since most such investments are required by environmental laws. Furthermore, utilities frequently use tax-exempt pollution control bonds as a major source of capital for financing new power plant construction, which is not the purpose of the tax-exempt bonds. Some utilities have been able to use pollution control bonds to finance more than 30 percent of a projected investment in new generating facilities. Thus, rather than encouraging pollution control, this costly tax expenditure appears to subsidize investments by electric utilities.

Deduction for preferred stock dividends

Even though utilities already receive disproportionately large benefits from basic provisions in the tax code such as accelerated depreciation and interest deductions, the code offers additional special provisions for utilities. One of these is a special deduction for utility preferred stock. Section 247 of the Internal Revenue Code allows utilities to deduct a portion of the cost of dividends paid on preferred stock from their taxable income. This unique provision was enacted in 1942 to aid wartime expansion of utility facilities. It has remained in law for 41 years, despite the apparent lack of any rationale in peacetime. Corporate taxpayers which purchase qualifying utility preferred stock also receive a special tax deduction under Sec. 244 of the Internal Revenune Code. Together, Sections 244 and 247 cost the U.S. Treasury about $24 million annually for all utilities, as estimated by the Treasury.

Dividend reinvestment program

As part of the Economic Recovery Tax Act of 1981, Congress provided another tax benefit intended just for utilities. The dividend reinvestment program allows certain utility stockholders to postpone payment of federal income taxes associated with utility stock dividends, provided that these dividends are reinvested in new stock of that company. This provision helps utilities raise capital at a reduced cost, but entails a tax expenditure by the U.S. Treasury. the Senate Finance Committee has estimated that this program will cost the U.S. Treasury $900 million for 1983–85.

Due to this unique combination of tax benefits, the current federal tax expenditures for electric utilities amounts to $9.7 billion annually. The table below summarize these expenditures.

Approximate annual Federal tax expenditures for electric utilities

	Billions
Investment tax credit	$1.5
Accelerated depreciation and shortened tax lives	2.0

	Billions
Interest expense deductions	5.3
Pollution control bonds	6
Dividend reinvestment program	.3
Total	9.7

Benefits from Tax Normalization

While the focus of the hearing today is on tax expenditures, the full benefit of the tax code for utilities goes beyond their reduced tax payments. Currently, Sections 46(f) and 1671(l) of the Internal Revenue Code require that utility tax benefits receive normalized accounting treatment. This requires utilities to charge their ratepayers for taxes as if no tax credits or deferrals had been received. Consumers and many regulators prefer an accounting alternative known as "flow-through", whereby a utility passes its tax savings on to consumers without delay. This practice is not allowed by current federal law.

A utility normalizes its ITC benefits from a new power plant by charging its customers as if there were no tax credit. The deferred ITC's a utility collects from its customers are placed in a special account. This money is refunded to ratepayers over the life of the plant, a process taking approximately forty years.

Savings from accelerated depreciation and shortened tax lives are normalized by a different method. When a utility receives a tax deferral for a new investment, it charges its customers as if there were no deferral. The taxes owed to the government are placed in a deferred tax account and held there until they are paid to the Internal Revenue Service. If a utility continues making new investments, it can keep postponing a large portion of its tax liability indefinitely.

Deferred taxes and tax credits are available to the utility for investments in new power plants.

In a report released last month by the Enviromental Action Foundation, the nation's one hundred largest power companies were surveyed and tax overcharges amounting to $3.7 billion in 1981 were reported, chiefly as a result of the normalization requirement. These unpaid taxes have come to be known as "phantom taxes," a term originating with former Federal Power Commission Chair Howard Morgan.

The survey found that the electric utilities studied had billed ratepayers for $5.0 billion in federal income taxes in 1981, but reported paying only $1.3 billion to the IRS. Thus, for every dollar paid to the government, the companies retained over $3.00. Commonwealth Edison Co. in Illinois, for example, charged its customers $208 million for federal income taxes, but reported paying only $12 million to the IRS, resulting in an overcharge of $196 million. This was the largest tax overcharge in the country. Moreover, this company had accumulated over $1.4 billion in its deferred tax accounts at the end of 1981, according to the company's annual report filed with the Federal Energy Regulatory Commission (FERC). For each of the 100 utilities which we surveyed, the tax overcharge and accumulated deferred tax amounts are listed in the table included as Exhibit 1 of our testimony. The ten highest ranking utilities in phantom tax charges and the ten highest in the size of their accumulated deferred tax accounts are listed as Exhibit 2.

Economic Normalization

Another provision contained in Section 46(f) allows utilities to earn a hidden profit from the normalization of their tax credits. Under federal law, utility ratepayers must provide capital for ten percent of a new power plant through the normalization of ITCs. Utility regulators generally favor a procedure called "economic normalization," which requires that these deferred ITCs be deducted from the utility's rate base and also be refunded to ratepayers in later years.

Regulators generally use economic normalization to treat deferred taxes arising from accelerated depreciation and shortened tax lives, but federal law prevents them from using economic normalization for ITC benefits. Thus, the law enables utilities to earn a profit on the portion of their investments that are financed by ratepayers through deferred tax credits.

Environmental Action Foundation has calculated that the extra profits that electric utilities earn from the ITC totaled $762 million in 1981. We estimate that the sum will increase to about $3 billion annually by the 1990s.

State utility regulators are quite concerned that federal restrictions on the regulatory treatment of utility tax benefits prevent them from properly exercising their regulatory responsibilities. The collection of phantom taxes and the additional profit derived from the tax code should not be outside the purview of state regulators. The National Association of Regulatory Utility Commissioners has advocated repeal of

Sections 46(f) and 167(1) of the Internal Revenue Code for many years. While state regulators do not necessarily oppose the use of normalization, they object to having their regulatory functions interfered with by the federal government.

The need for utility tax breaks

Most of these tax subsidies for electric utilities were adopted at a time when the power companies were engaged in a large expansion program to meet a rapidly growing demand for electricity. Times have changed. The growth in power demands has been declining over the past ten years and has now come to a virtual standstill. The power industry currently has a record 39% generating reserve margin. (Source: Edison Electric Institute) Excess generating capacity is costing consumers billions of dollars in higher electric bills, yet the federal government continues to offer the utilities billion-dollar incentives for investing in new power plants.

These federal tax benefits encourage inefficient management by the power companies. By providing a large pool of cost-free capital for power plant construction, phantom taxes make the financing of new construction artifically inexpensive. Moreover, the perpetual postponement of taxes gives utilities an incentive to keep expanding and building new power plants, to avoid paying their accumulated deferred taxes. Power companies often become locked into a growth cycle which is difficult to break out of. According to former California utility regulator Robert Batinovich:

"The desire for tax credits often undermines the responsibility of prudent utility management to determine whether growth is reasonable in light of foreseeable customer requirements. The present tax laws stimulate growth regardless of need within a particular service territory." (Quoted from "A Sensible Substitute for the Federal Income Tax on Utilities," in Public Utilities Fortnightly, July 21, 1977, pp. 13–14.)

Many tax experts have questioned the wisdom of offering investment incentives to a regulated monopoly. As Rep. Al Ullman pointed out in 1962:

"In view of the fact that utilities are regulated monopolies with guaranteed rates of return and with a utility responsibility to provide all the investment needed to meet demand, I can see absolutely no reason for offering them a tax incentive to do what they are required to do anyway." (Congressional Record, v. 108, p. 5319, 1962)

In fact, when the ITC was originally proposed in 1962, Treasury Secretary Douglas Dillon argued that utilities should be exempted from this provision. In that year, Congress adopted a 7 percent ITC, but limited tax credits for utilities to 3 percent. Not until 1975, when Congress increased the ITC to 10 percent, were utilities allowed the same ITC as other industries.

CONCLUSION

The current network of federal tax benefits to the electric utility industry is costly both to the federal treasury and to consumers. Further, it encourages inefficient utility management decisions to pursue expensive means of meeting future generating needs at a time when least-cost approaches should be vigorously pursued. During this period of mounting deficits, the federal government should not be offering almost $10 billion annually in investment incentives to companies which are already required by law to make the investment necessary to provide adequate service.

Environmental Action urges the Ways and Means Committee to consider the following changes in the Internal Revenue Code as it pertains to electric utilities:

(1) Reduce or eliminate the ITC for electric utilities;

(2) Equalize the tax lives for all generating plants at a minimum of 15 years, in order to eliminate the bias against coal plants in the current law;

(3) Eliminate special preferences for utilities in the tax code, such as the deduction for preferred stock dividends and the dividend reinvestment provision;

(4) Remove the full 10 percent ITC from the depreciation base;

(5) Remove federal restrictions on the ability of state utility commissions to determine the appropriate accounting procedures to be used for electric utility tax benefits.

These changes in the tax code could increase federal revenues by between two and four billion dollars annually. At the same time the impact on ratepayers can be mitigated by removing the federal restriction on the flow-through of tax benefits to ratepayers.

Thank you for this opportunity to share with you our views on the tax treatment of electric utilities and on the potential for providing additional revenues for the Treasury by giving less preferential treatment to electric utilities.

[Exhibit 1]

ELECTRIC UTILITY PHANTOM TAXES 1981

Utility	Rank by kWh sales	Taxes paid	Taxes charged	Tax overcharge	Over-charge rank	Accumulated deferred taxes	Accumu-lated deferred tax rank
Alabama Power Co	11	−$17,790,786	$83,787,946	$101,578,732	9	$540,271,804	11
Appalachian Power Co	13	5,042,409	42,176,514	37,134,105	39	115,208,567	62
Arizona Public Service Co	50	8,205,862	12,790,916	4,585,054	94	17,933,717	100
Arkansas Power & Light Co	25	6,469,069	57,337,906	50,868,837	23	279,552,020	23
Atlantic City Electric Co	94	13,950,679	24,994,094	11,043,415	76	100,991,603	66
Baltimore Gas & Electric Co	35	57,281,854	86,699,932	29,418,078	48	259,666,899	27
Boston Edison Co	55	−7,080,867	60,249,845	67,330,712	16	326,005,844	21
Carolina Power & Light Co	14	−5,292,895	107,344,543	112,637,438	5	544,636,655	9
Central Hudson Gas & Electric Co	95	6,099,117	11,550,400	5,451,283	89	31,860,716	96
Central Illinois Light Co	98	14,271,300	28,289,391	14,018,091	70	171,120,300	43
Central Illinois Public Service Co	72	5,045,306	37,395,420	32,350,114	44	221,326,936	37
Central Louisiana Electric Power Co	99	4,723,506	6,452,458	1,728,952	97	61,679,969	83
Central Maine Power Co	87	−1,084,580	8,318,434	9,403,014	79	75,954,115	80
Central Power & Light Co	45	21,205,000	53,843,478	32,638,478	43	249,980,294	30
Cincinnati Gas & Electric Co	43	68,213,344	118,798,091	50,584,747	24	169,253,188	46
Cleveland Electric Illuminating Co	36	7,492,146	67,574,752	60,082,606	18	261,556,817	26
Columbus & Southern Ohio Electric Co	49	2,637,951	31,321,232	28,683,281	50	96,885,870	68
Commonwealth Edison Co	3	12,022,387	208,122,034	196,099,647	1	1,407,817,721	1
Connecticut Light & Power Co	63	−1,310,593	27,902,140	29,212,733	49	65,533,899	82
Consolidated Edison Co. of N.Y	15	190,900,000	203,710,000	12,810,000	73	541,567,865	10
Consumers Power Co	20	−6,664,307	21,281,145	27,945,452	51	692,525,477	6
Dallas Power & Light Co	56	29,822,422	48,431,634	18,609,212	64	127,280,463	61
Dayton Power & Light Co	68	5,793,200	52,418,200	46,625,000	30	96,868,500	69
Delmarva Power & Light Co	78	10,585,446	33,957,579	23,372,133	59	106,705,832	65
Detroit Edison Co	10	4,200,067	64,226,581	60,026,514	19	562,398,467	8
Duke Power Co	5	12,927,338	118,792,022	105,864,684	8	745,613,561	5
Duquesne Light Co	47	8,995,287	56,950,553	47,955,266	26	272,391,473	24
Florida Power & Light	7	33,669,757	148,243,740	114,573,983	4	951,709,801	2
Florida Power Corp	32	10,973,817	65,131,712	54,157,895	22	438,157,875	15
Georgia Power Co	6	7,912,364	116,492,679	108,580,315	7	920,542,097	3
Gulf Power Co	89	8,588,533	22,074,262	13,485,729	71	128,108,040	59
Gulf States Utilities Co	16	7,962,331	31,183,186	23,220,855	60	320,832,911	22
Hartford Electric Light Co	90	412,425	15,716,744	15,304,319	68	34,619,297	94
Hawaiian Electric Co	97	11,819,572	19,003,128	7,183,556	86	86,931,597	75
Houston Lighting & Power Co	4	44,167,628	165,981,342	121,813,714	3	607,159,791	7
Idaho Power Co	58	1,836,000	18,878,884	17,042,884	66	135,948,574	55
Illinois Power Co	46	15,116,181	71,392,833	56,276,652	20	345,467,526	20
Indiana & Michigan Electric Co	24	6,543,980	50,780,721	44,236,741	31	252,835,968	29
Indianapolis Power & Light Co	70	12,368,975	29,318,327	16,949,352	67	160,827,984	51
Jersey Central Power & Light Co	52	−7,462,293	15,019,338	22,481,631	61	229,589,429	34
Kansas City Power & Light Co	73	4,703,827	40,433,965	35,730,138	41	175,898,066	42
Kansas Gas & Electric Co	77	3,317,000	7,645,000	4,328,000	95	87,169,244	73
Kansas Power & Light Co	89	3,875,813	28,202,826	24,327,013	58	152,412,476	53
Kentucky Power Co	86	996,289	8,455,223	7,458,934	85	56,257,783	86
Kentucky Utilities Co	65	5,205,971	31,190,167	25,984,196	55	165,282,167	48
Long Island Lighting Co	48	1,885,862	85,879,083	83,993,221	10	114,806,869	63

ELECTRIC UTILITY PHANTOM TAXES 1981—Continued

Utility	Rank by kWh sales	Taxes paid	Taxes charged	Tax overcharge	Over-charge rank	Accumulated deferred taxes	Accumu-lated deferred tax rank
Louisiana Power & Light Co	22	11,495,772	66,444,984	54,949,212	21	205,933,069	39
Louisville Gas & Electric Co	76	5,790,501	33,339,288	27,548,787	52	171,016,100	44
Massachusetts Electric Co	61	17,129,855	22,079,155	4,949,300	91	82,697,176	77
Metropolitan Edison Co	75	22,090,359	−13,805,347	−35,895,706	100	134,739,886	56
Minnesota Power & Light Co	71	4,416,992	30,842,576	26,425,584	54	132,987,204	57
Mississippi Power Co	82	16,717,540	25,469,435	8,751,895	81	110,289,959	64
Mississippi Power & Light Co	67	18,545,713	20,408,420	1,862,707	96	93,747,154	70
Monongahela Power Co	57	12,303,210	17,033,127	4,729,917	93	56,823,863	85
Montana Power Co	74	−737,069	7,085,009	7,822,078	83	78,257,686	79
Nevada Power Co	91	5,933,457	18,795,445	12,861,988	72	34,139,972	95
New Orleans Public Service Co	92	7,088,000	5,360,005	−1,727,994	99	46,277,261	91
New York State Electric & Gas Co	62	6,511,400	43,844,000	37,332,600	37	90,024,148	71
Niagara Mohawk Power Co	12	6,996,000	46,277,595	39,281,595	36	170,713,000	45
Northern Indiana Public Service Co	51	−16,323,708	52,131,355	68,455,063	15	391,257,014	17
Northern States Power Co (Minn.)	27	57,228,488	87,569,881	30,341,393	47	484,948,686	12
Ohio Edison Co	29	0	71,658,531	71,658,531	13	141,393,477	54
Ohio Power Co	9	5,213,248	17,852,808	12,639,560	74	130,554,865	58
Oklahoma Gas & Electric Co	28	16,770,000	64,521,461	47,751,461	28	228,064,560	36
Pacific Gas & Electric Co	2	41,054,639	80,483,606	39,428,967	35	50,167,581	89
Pacific Power & Light Co	23	−5,058,860	4,699,046	9,757,906	78	60,703,733	84
Pennsylvania Electric Co	60	17,567,442	18,730,321	1,162,879	98	164,887,461	49
Pennsylvania Power & Light Co	26	15,611,134	46,850,616	31,239,432	46	230,874,562	33
Philadelphia Electric Co	[illegible]	25,220,922	101,418,421	76,197,499	12	483,537,971	13
Portland General Electric Co	39	6,530,993	43,637,801	37,106,808	40	69,045,122	81
Potomac Edison Co	54	14,021,868	22,767,660	8,745,792	82	86,193,645	76
Potomac Electric Power Co	37	19,560,388	67,200,494	47,640,106	29	264,498,714	25
Public Service Co of Colorado	42	20,445,000	52,543,227	42,098,227	32	167,311,322	47
Public Service Co of Indiana	33	7,456,000	70,941,413	63,485,413	17	459,281,545	14
Public Service Co of New Hampshire	88	−1,579,568	24,381,351	25,960,919	56	45,698,429	92
Public Service Co of New Mexico	93	13,040,450	19,265,255	6,224,805	87	127,918,028	60
Public Service Co of Oklahoma	40	−22,415,640	25,396,224	47,811,864	27	258,043,266	28
Public Service Electric & Gas Co	17	6,188,309	118,736,935	112,548,626	6	813,923,610	4
Puget Sound Power & Light Co	38	4,064,748	24,329,000	20,264,252	63	87,041,947	74
Rochester Gas & Electric Corp	84	3,421,445	18,580,504	15,159,059	69	55,032,742	87
San Diego Gas & Electric Co	66	−2,971,035	22,189,418	25,160,453	57	18,200,812	99
South Carolina Electric & Gas Co	59	5,521,700	54,449,068	48,927,367	25	233,614,580	32
Southern California Edison Co	1	33,950,492	161,346,383	127,395,891	2	247,710,562	31
Southwestern Electric Power Co	44	15,939,100	43,472,175	27,533,075	53	215,808,075	38
Southwestern Public Service Co	53	69,210	21,200,245	21,131,035	62	89,080,337	72
Tampa Electric Co	64	25,460,101	34,758,766	9,298,665	80	176,018,607	41
Texas Electric Service Co	31	53,356,311	90,550,528	37,194,217	38	228,280,221	35

ELECTRIC UTILITY PHANTOM TAXES 1981—Continued

Utility	Rank by kWh sales	Taxes paid	Taxes charged	Tax overcharge	Over-charge rank	Accumulated deferred taxes	Accumulated deferred tax rank
Texas-New Mexico Power Co	96	−835,593	3,996,339	4,829,932	92	25,240,741	98
Texas Power & Light Co	19	56,879,211	97,628,114	40,748,903	33	364,102,870	18
Toledo Edison Co	79	8,578,784	40,841,609	32,262,825	45	99,192,274	67
Tucson Electric Power Co	81	−17,283,000	16,897,603	34,180,603	42	79,654,249	78
Union Electric Co	21	−7,946,000	69,260,406	77,206,406	11	361,406,000	19
Utah Power & Light Co	41	5,131,300	45,345,883	40,214,583	34	203,497,949	40
Virginia Electric & Power Co	8	22,753,784	93,669,272	70,915,488	14	435,648,899	16
Washington Water Power Co	69	4,686,709	10,447,888	5,761,179	88	27,918,601	97
West Penn Power Co	39	26,672,763	44,261,553	17,588,790	65	153,917,069	52
West Texas Utilities Co	100	3,523,900	8,865,200	5,341,300	90	50,568,015	88
Wisconsin Electric Power Co	34	31,556,383	41,684,287	10,127,904	77	163,127,822	50
Wisconsin Power & Light Co	80	23,119,218	30,688,718	7,569,500	84	42,038,204	93
Wisconsin Public Service Corp	83	7,720,000	18,873,000	11,151,000	75	46,436,680	90
Total		1,288,739,360	4,963,036,181	3,674,297,120		22,976,133,392	

[Exhibit 2]

Top 10 electric utility phantom taxes, 1981

	Millions
1. Commonwealth Edison Co	$196.1
2. Southern California Edison Co	127.4
3. Houston Lighting & Power Co	121.8
4. Florida Power & Light Co	114.6
5. Carolina Power & Light Co	112.6
6. Public Service Electric & Gas Co	112.5
7. Georgia Power Co	108.6
8. Duke Power Co	105.9
9. Alabama Power Co	101.6
10. Long Island Lighting Co	84.0

Top 10 accumulated deferred taxes and tax credits, Dec 31, 1981

	Billions
1. Commonwealth Edison Co	$1.408
2. Florida Power & Light Co	952
3. Georgia Power Co	921
4. Public Service Electric & Gas Co	814
5. Duke Power Co	746
6. Consumers Power Co	693
7. Houston Lighting & Power Co	607
8. Detroit Edison Co	562
9. Carolina Power & Light Co	545
10. Consolidated Edison Co. of New York	542

Mr. GIBBONS. Thank you very much for coming.

I recognize what you say there and I have often thought that the best solution to this whole problem would be to take the public utility industry off the tax rolls and not have all this silly pass-back and forth that we have, phantom charges and everything else.

I realize we would probably be foregoing that $1.7 billion but it looks to me like when we got through we would end up with a more logical rate structure and less incentive to build unneeded facilities and we would have also solved the equity problem between public utilities that are owned by stockholders and public utilities that are owned by, or people who are living in areas of stockholder-owned utilities and people who live in areas that have governmentally owned utilities.

I can remember from my experience in Florida years ago that we had cities practically giving away power in order to get customers and we had stockholder-owned utilities that were regulated by the public utility commission and it was really a ridiculous thing.

I have never been able to solve this riddle.

Mr. MORGAN. Well, I am aware, Mr. Chairman, that there was a bill introduced by Mr. Stark a few years ago that would have done exactly what you suggested and considering what the CBO found, that they expect to see the electric utilities stop paying Federal taxes under the current law in 1 or 2 years——

Mr. GIBBONS. That will obviously happen under the appreciation schedule adopted.

Mr. MORGAN. It is likely.

Under those circumstances we might well be better off if the utilities were exempted from Federal income taxes. Part of Mr. Stark's proposal was to replace the income tax with an excise tax to raise approximately the same revenues that the utilities pay in now.

Mr. GIBBONS. But if the public utilities are properly regulated and that is a big "if," and a very complicated thing to do, I understand. The economy would in effect break even if we just took them off the tax rolls and treated them all the same and said, hey, forget about all this stuff. Just do what is best for the utility and the consumer.

Mr. MORGAN. If you did that now you would be out about $1.7 billion from the Treasury. In terms of our organizations that I am representing here today, we do believe that private electric companies, as corporations, should be liable for Federal income tax. Of course the utilities themselves are very strongly opposed to the Stark proposal to take them off the tax rolls.

Mr. GIBBONS. I know. I have tried that out on them every time they come in. I ask them that and they all shudder when I ask if we should take them off the rolls.

Let me ask you, I have a bill in here, I don't know whether you looked at it or not, that has to do with the decommissioning of these big nuclear plants. Right now as I understand it utilities are not putting aside any funds out of current earnings to decommission these plants. I recognize that you represent the environmental action group and let me ask you, is my real concern a problem that we don't have anything that really requires them to start decommissioning cost reserving because it looks to me like what we are doing is passing on to future generations a tremendously high liability in decommissioning these plants.

Mr. MORGAN. I am not an expert on this issue, but I am somewhat familiar with it. My understanding is that most utilities are putting some money away for decommissioning. But for certain plants there is no money being put away. I have seen numbers suggesting—based on test reactors that have been decommissioned—that it is possible that the cost of taking apart a nuclear plant could be higher than the cost of building them.

Mr. GIBBONS. Yes.

Mr. Morgan. Which has frightening implications. I don't know of any utility putting away that kind of money for the future for decommissioning. So this is certainly a legacy that we are leaving for our grandchildren.

One thing we are very concerned about is that virtually all the utilities that are putting away money for decommissioning, they are putting it away by investing in other powerplants that they own rather than putting it in a separate fund like a sinking fund. We would like to see—when I say "we" I am speaking only for Environmental Action and not for the other 14 organizations——

Mr. Gibbons. I understand.

Mr. Morgan [continuing]. Would like to see a sinking fund requirement so that we can be sure that when they put this money away that they are not going to have it tied up in their own investments, that in fact some outside trustee such as a bank would have control over the money. Then we can feel confident that that money will be there by the time decommissioning comes around.

Some utilities would like to see large pots for decommissioning just so they can get their hands on that money to use it to build more powerplants. I think that is really going to defeat the purpose of decommissioning funds if they are able to do that.

Mr. Gibbons. I appreciate your looking at my bill if you have not seen it.

Mr. Morgan. I have seen it.

Mr. Gibbons. I would appreciate a critique on it from you.

Mr. Morgan. I would be happy to do that.

[The information follows:]

H.R. 2820—Tax Deduction for Decommissioning Costs

(By Ruth Caplan)

H.R. 2820 would allow utilities to treat income collected from taxpayers for future nuclear decommissioning costs as a current expense for income tax purposes. Rather than owing taxes on this income, the utility would be able to treat the income as an expense which would reduce taxes owed on other income.

The problem with this proposal as it stands is that utilities have two basic methods of dealing with funds which they collect for future decommissioning. Most frequently, a separate account is established to keep track of the funds, but the money itself is placed in internal unsegregated reserves. This means that the funds paid by ratepayers for decommissioning are available to the utility for use as current income. Some utility commission, however, have required that decommissioning funds be placed in a dedicated fund such as an "external sinking fund" which is unavailable to utilities for other purposes.

H.R. 2820 as written does not distinguish between these alternative methods for accumulating decommissioning funds. By allowing utilities to take an expense deduction for internal unsegregated reserves which are actually used as current income, the bill appears to violate Section 162 of the Internal Revenue Code which defines "expenses" for tax purposes. Under the definition, expenses must "be paid or incurred during the taxable year." This definition has been further clarified by the courts in *National Can Corporation* vs. *U.S.* which states:

"In its most general acceptance, the term 'expense,' when used to determine tax deductions, means money spent; disbursing of money; drain on one's finances; incurring in the tax year of an obligation to pay; or employment and consumption of time and labor (D.C. Ill. 1981 520 F. Suppl. 567).

If, on the other hand, the utility places the funds in an external sinking fund, the money is not available as current income and can be legitimately considered an expense for tax purposes.

For this reason, the bill should be modified so that an expense deduction is not allowed for funds used as income. This can be done by limiting the bill to decommissioning funds which have been placed in an eternal sinking fund. Since these funds are not available for other purposes, a decommissioning "expense" has actually been incurred.

By modifying the bill in this manner, the consumer benefit of not having to pay current taxes on funds collected for a future expense can be retained and the "gross up" problem eliminated without giving the utilities a tax windfall in the process. In order to obtain this benefit for consumers, state utility commissions must require that the funds be physically isolated for their intended purpose.

Currently four states have adopted external sinking funds: Colorado for Fort St. Vrain; Massachusetts for Yankee Rowe; Pennsylvania for all its reactors; and California for all its reactors, having recently passed a law which will soon be implemented.

Mr. GIBBONS. Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman.

We have heard about a lot of dilemmas in this area, in this Tax Committee. Those of us who have been here for any length of time see the utilities come in and say, look, the rating agencies are not willing to let us set anything aside for capital investment. Therefore you have to give us some special tax preference that will permit us to achieve some capital collection capability that we can then use for the future consumer of our area.

Mr. MORGAN. Excuse me, did you say——

Mr. CONABLE. Then if the rating agencies come back and say no, we want to flow the tax preference through——

Mr. MORGAN. Are you talking about rating agencies or regulators?

Mr. CONABLE. I am talking about the rate agencies. We want to flow your tax preferences through, they say, to the consumers and reduce the value of any capital preference you get as a result of what the Ways and Means Committee has done for you.

That causes them to come back and say you have to give us something else—dividend reinvestment or some other special deal. Unfortunately, that becomes the norm for other industries coming in and seeking similar concessions even though they are not regulated.

So we are constantly being asked to make up for the failures of the rate agencies to provide adequate capital accumulation capabilities in the rate structure.

They constantly are deciding they want to benefit current consumers, because they are politically appointed bodies themselves, at the expense of future consumers who, of course, then have to pay additional costs for capital accumulation. Next, they come back to us and ask for more.

I don't know how we can avoid this but it has driven us up the wall here from time to time, this business of normalization which is a way of converting a tax preference into a boon to consumers. And what we wind up doing is having the taxpayers subsidize the consumers, in effect.

Mr. GIBBONS. They do that through flowthrough.

Mr. CONABLE. Yes.

Mr. GIBBONS. Stretch it out, yes.

Mr. CONABLE. Flowthrough rather than normalization, flowthrough is the word I should have used.

I don't know how we can avoid this. We have several States particularly bad at this and who always are presenting us with very serious problems here. The theory is somehow that the tax system can be used to bail out any excess out there in the bureaucratic process.

I don't know what you want to say about that but the tax system should not be used to try to correct for things like that. We ought to have rate structures that permit adequate capital accumulation even though it means that your current consumers have to pay a little more in order that later consumers will have the capacity they need. We don't get that now.

I don't know what to do about it except that I am sure that this committee is not going to continue to bail out rate actions or utilities because they have no capital capability.

Mr. GIBBONS. That is Mr. Dingell's field. Maybe we ought to let him legislate on that and pass a bill stating that regulating actions will provide long-term rate structures that provide for the return necessary to attract the needed and necessary capital to the business, but we won't provide more tax gimmicks for them.

Mr. MORGAN. My understanding is that in virtually every State any decision by a utility commission is subject to court review and that in many cases utility commissions which did not provide what the courts felt was adequate means for raising capital, those decisions were overturned. There is quite a bit of difference of opinion on how much building utilities need be doing right now. I can say for myself that we have found with the industry's own figures that the utility industry's generating reserve margin is at a record 39 percent now which is more than double what the regulators say they need.

So there is serious questions about how much capital they need to be raising now.

Mr. GIBBONS. That may be.

Mr. MORGAN. In the long run they need to be able to raise capital for certain things whether it is building powerplants or solar facilities, making conservation loans, whatever, we have no objection to their raising capital but we believe that when the utility needs to raise capital it should have to go to Wall Street like other firms do and pay the prevailing rate.

Here we find that almost $1 for every $3 they need to raise for capital they can get from the Federal Government because of the way the Internal Revenue Code is written.

We certainly think that is a lot more than they need. There is no question that the utility regulators are concerned about this problem. A lot of regulators feel that the decision should be theirs as to whether and to what extent the tax benefits provided by the Federal Government are passed through to utility ratepayers. Right now they don't have that power and as a result we have calculated that the electric utilities are making a hidden profit of about $760 million a year up by not deducting the ITC from their rate base which the utility commissions cannot do because of the way the Federal law is written.

The utilities are now earning a return on the portion of the powerplant financed with the ITC's and the Federal law says they have to make that return and the utility regulators cannot touch it or say anything about it.

That is the return we are talking about.

Mr. GIBBONS. I appreciate your coming in and saying that because way back in 1961 and 1962 when we considered the ITC for utilities, the utilities argued partially successfully that we should not allow them to take the ITC because that should be included in the rate structure.

And we put them in half way and then a few years later they got in all the way. I didn't put them in any time, but I have lost that battle. I fought it up and down here to no avail.

I am ready to take all regulated public utilities off of the U.S. tax rolls because if we don't take them off soon they are going to be off anyway for any practicalities—most are already off. It just screws up unnecessarily a proper ratesetting.

Do you agree with that?

Mr. MORGAN. I certainly agree that the present situation is the worst possible one.

I think we would be far better off if the utilities were not required to pay Federal income tax and perhaps pay an excise tax instead, which would be better than we are now.

I would still prefer to see a situation where the utilities pay taxes like other businesses do.

Mr. GIBBONS. I would, too, but you will never get there. I have no objection to that, but we are never going to get there. I have lost that battle way back in 1969. Or was it 1971? One of those years. It has gotten worse ever since.

Mr. MORGAN. Yes.

Mr. GIBBONS. And now I don't see a way out of it. One of the problems is the basic problem that you have all these consumers who are paying for power who live in areas where the governmental agency owns the powerplant and, therefore, pays no Federal tax. You have right next door, maybe just across the street or across the river or across the boundary line of some kind, another type of utility delivering the same product that is subject to local taxes and Federal taxes, too, and so you are really creating all kinds of crazy-quilt electrical costs to consumers all across the United States by the way we tax these entities.

I would like to straighten it all out and have them all pay taxes, but we would still miss a heck of a lot of them that are allegedly governmentally owned. The Government has now leased out some of their plants to some tax shelter or through a municipal bond thing and got a management agency in there running the utility and so it is a fiction of them being a governmental agency or instrumentality of a State or local subsidivision of a State—it is purely fiction.

Mr. CONABLE. It is not related to taxes though, Sam, but the preferential electrical rates, for instance, given by public power authorities has to figure in that.

Mr. GIBBONS. That is what I mean. The preferential rate thing is an unfair competitive advantage that disrupts our common marketplace in the United States here.

Mr. MORGAN. It is pretty difficult to sort that out because there are so many different subsidies going to different utilities.

Mr. GIBBONS. I know. It is ridiculous.

Mr. MORGAN. There is quite a debate in the industry over who gets the biggest subsidies, the private or public utilities.

Mr. **Gibbons**. I think the public stockholder-owned utilities are escaping taxes.

Mr. **Morgan**. It is difficult to determine. For one thing, most of the publicly owned utilities make payments in lieu of taxes to the local governmental entities. And I think that was a political decision many of them made in order not to be able to be charged with not paying taxes. You get a different answer depending on whether you figure that in.

Mr. **Gibbons**. Most of them I run into are flat busted and running around here trying to sell their plant to some doctor or lawyer or syndicate of them. So they can sell off some depreciation or investment tax credit. That is happening right now this very minute all over the United States.

Mr. **Conable**. Kind of makes you proud, doesn't it?

Mr. **Gibbons**. So we really got a screwed up setup.

On that note I think we ought to close this hearing. Probably should have closed it a long time ago.

Thank you very much.

Mr. **Morgan**. Thank you.

Mr. **Conable**. Thank you, sir.

Mr. **Gibbons**. The hearing will be adjourned.

[Whereupon, at 3:32 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the Ad Hoc Coalition on Estate Taxation

I. INTRODUCTION

We appreciate the opportunity to submit this statement on behalf of the Ad Hoc Coalition on Estate Taxation. Members of the Coalition supporting this statement are listed on Appendix A.

This Coalition had its roots back in 1981. At that time, our various member assocations met to coordinate their position on estate and gift tax reform, in connection with the Congressional hearings preceding the enactment of the Economic Recovery Act of 1981. Earlier this year, we again convened the group because of proposals to take away the gains we made in 1981 and because much is still needed by way of estate and gift tax reform.

Not surprisingly, our members include many organizations comprised of individuals who own a family business, farm, ranch, or timber stand. To be an economically viable unit, the family enterprises must often include from three quarters of a million to several million dollars of illiquid assets. It is often not feasible to sell off a portion of these assets to pay estate taxes because such a sale would leave a unit which is too small to be economically viable. Borrowing to pay estate taxes is often not feasible because of the other credit needs of the business or the costs of servicing the debt. Also, because of the business needs for additional capital, many owners of such properties cannot afford to provide a fund for estate tax liabilities through insurance or otherwise. It is these persons and their families who are most severely impacted by the imposition of the estate and gift taxes.

We hope that through our coordinated approach, Congress will reaffirm its commitment made in 1981 to make our estate and gift tax more equitable to all Americans.

II. BACKGROUND

In 1981 hearings held by both the House and Senate amply documented the substantial need for estate and gift tax reform. Those hearings included statements from owners of small businesses, agricultural enterprises, livestock and timer. In addition, those hearings included statements both from tax professionals and economists describing the need for estate and gift tax relief.

On the basis of those hearings, this Committee approved legislation, ultimately incorporated in the Economic Recovery Tax Act of 1981 (ERTA), which provided substantial reductions in the hardships caused by the estate and gift tax.

ERTA increased the credit that might be applied to estate and gift tax, the effect of which was to increase the exclusion from $175,6000 for decedents dying prior to 1981 to $600,000 for decedents dying after 1986; it reduced the maximum estate rate from 70 percent for decedents dying prior to 1981 to 50 percent for decedents dying after 1984; it provided an unlimited marital deduction; it improved the special use valuation; it increased the annual gift tax exclusion; and it made other, more technical, improvements.

III. THE "FREEZE" PROPOSAL

When the increase in the credit and the decrease in the maximum rate become fully effective, we will have made substantial strides toward reducing the adverse economic effects of the estate and gift tax regimes. Some in Congress, however, are proposing to curtail this relief before it even has a chance to go into effect. Under such proposals, the credit would be frozen at an effective exclusion of $275,000; it would not be permitted to increase to an effective exclusion of $600,000. And the maximum rate would be frozen at 60 percent; it would not be permitted to decline to 50 percent.

But the need for these tax reductions is as vital today as it was back in 1981. And the justifications for these reductions are as valid today as when ERTA was first enacted.

IV. WHY THE ESTATE AND GIFT TAX RELIEF PROVIDED BY ERTA MUST BE PERMITTED TO BECOME EFFECTIVE

To understand why ERTA provided estate and gift tax relief, an overall evaluation of the fairness of estate and gift tax may be helpful. This might be accomplished by considering the tax's efficiency and equity. Despite the ERTA amendments that have thus far become effective, the estate and gift tax continues to be both inefficient and inequitable.

The current tax is inefficient as it discourages capital intensive investments. Capital intensive investments, which offer the greatest potential for economic growth, are characteristically illiquid as they include factories and equipment. Because of the substantial tax that may be imposed upon death—60 percent today—those in the best position to make meaningful capital investments are encouraged, instead, to make investments in liquid assets with which their estate might easily satisfy their estate tax obligations. Thus, at current levels, the estate tax continues to frustrate our national goals of stimulating capital expenditures.

The estate tax is also inequitable as it favors consumption over savings. Two otherwise equally situated taxpayers—one spending all that he earns, the other saving as much as possible—are taxed dramatically differently upon their death. The taxpayer who consumed his earnings has no estate, and no estate tax. The taxpayer who saved, however, is subject to an estate tax as a result of having acquired an estate.

Our tax policy should encourage, rather than discourage, savings. To the extent that it continues to discourage savings, we will not achieve the reinvestment in our nation's productive enterprises that is necessary if our economy is to prosper.

In this regard, it is worth noting that the estate and gift tax is justified by the assumption that the rate of savings is not affected by such tax. This assumption, however, is not true. A key motive underlying the savings of many persons is the desire to pass an estate on to one's heirs and beneficiaries. The desire to leave savings to others is made manifest by empirical evidence indicating that the great majority of accumulated wealth in the United States is transferred from generation to generation. Thus, most savings is eventually conveyed to others; it is not consumed during the saver's lifetime.[1]

V. H. RES. 216

Many members of Congress have recognized the importance of preserving the capital investment and savings stimuli provided by the 1981 Act. Many small businessmen, farmers, ranchers, and timber owners have altered their estate plans in reliance on the new provisions. To require them to revise their estate plans again within two years would be costly and would further the cynical attitude which many businessmen have developed after nearly a decade of almost continuous major revisions of the Tax Code.

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[1] These views on the impact of the estate tax also have support in the economic community. *See, e.g.*, Testimony of David Raboy, Institute for Research on the Economics of Taxation "Major Estate and Gift Tax Issues", Hearing before the Subcommittee on Estate and Gift Taxation, Committee on Finance, United States Senate, 97th Cong., 1st Sess. 119-136 (1981).

Congressman Daub, together with 92 cosponsors, have thus introduced H. Res. 216, which expresses the sense of the House that the estate and gift tax reductions made by ERTA but not yet effective should not be frozen. We applaud these efforts and would urge that Members of this Committee join their colleagues in assuring that the scheduled estate and gift tax reductions are permitted to go into effect.

VI. ADDITIONAL RELIEF WHEN THE TIME IS APPROPRIATE

Because of the concern over deficits, we recognize that now may not be the appropriate time for implementation of further estate and gift tax reductions. Nevertheless, because the current estate and gift tax system will remain inefficient and inequitable even after the ERTA reductions become fully effective, we would urge, when the timing is appropriate, that the maximum estate and gift tax rate be reduced to 20 or 30 percent, and that pro rata reductions be made for all rates. Were the tax reduced to these levels, its adverse effects on capital investment and savings would be significantly reduced.

Also, we would urge the indexing of the unified credit. In making this recommendation, however, we recognize that were the indexing of entitlements abandoned, this proposed indexing of the unified credit might be inappropriate. Nevertheless, since indexing currently is a part of both the income tax laws and the entitlement programs, we would urge its extension to the estate and gift tax area.

We also believe that Section 6166 of the Code should be revised to eliminate uncertain and awkward procedures for paying estate taxes in installments. Although ERTA made a number of significant and beneficial changes in the availability and operation of Section 6166, the provision remains unduly complicated and restrictive. The provisions of S. 1251, which was introduced in the Senate by Senator Symms, provide a sound basis for addressing these problems.

Additionally, we would support four amendments to the special use valuation provided by Section 2032A. Because subsection (e)(7) is inapplicable to many estates, and because of the difficulty and uncertainty in applying subsection (e)(8), we would urge that a "safe-harbor" be added to this section as an optional alternative to these other methods of valuation. This safe-harbor would permit qualified property to be valued at 50 percent of its fair market value at the time of death—a determination much more easily made. Such a safe-harbor is consistent with the valuations now available under subsection (e) (7) and (8), which we understand are in the range of 40 to 70 percent of fair market value.

Second, estates with businesses without substantial holdings of real property are unable to use the special use valuation, as there is no real property to specially value. Nevertheless, often these businesses are subject to the same liquidity problems as estates with businesses owning real property. And the imposition of the estate tax on such estates results in the forced sale of their businesses. We would thus urge that closely-held business property be made eligible for the special use valuation so that businesses without real property could avail themselves of the 50 percent "safe-harbor".

Third, while the ceiling on the amount of property eligible for the special use valuation was increased by ERTA from $500,000 to $750,000, this is woefully inadequate. Many small businesses own property valued far in excess of this amount. Accordingly, we would urge the removal of the $750,000 ceiling altogether.

Fourth, it is not clear under current law whether an election to use a particular method of valuation is irrevocable. Because of disputes that may arise in audit concerning certain aspects of formula valuation, it may be advantageous for an executor to change his method of valuation. As a solution to this problem, we suggest allowing an executor to change his method of valuation on an amended return at any time before the statute of limitations for assessing additional estate tax has run.

Finally, we would urge the immediate repeal of the generation skipping transfer tax (GSTT). This tax, which is not needed for revenue, is unduly complex. While Treasury has recently come forward with a proposal to further modify this tax, the merits of Treasury's proposal require substantial study as it is seeking to modify what for seven years has remained an unfathomable tax regime. Because of this unnecessary complexity, we would urge that GSTT be repealed now, and that the Treasury's proposal not delay such action.

APPENDIX A.—AD HOC COALITION ON ESTATE TAXATION MEMBERS SUPPORTING THIS STATEMENT

American Horse Council; Association of General Contractors; Forest Farmers Association; Forest Industries Committee on Timber Valuation and Taxation; National Association of Conservation Districts; National Association of Home Builders; National Association of Wholesaler Distributors; National Cattlemen's Association; National Cotton Council of America; National Milk Producers Federation; National Realty Committee; National Retail Merchants Association; National Wheat Growers Association; Small Business United; Southeastern Lumber Manufacturers Association; Southern Forest Products Association; United Egg Producers; and U.S. Chamber of Commerce.

STATEMENT OF NORMAN SHERLOCK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BUS ASSOCIATION

The American Bus Association would like to express its opposition to the possible enactment of a per barrel tax on imported crude oil. We base our opposition on three points. First, the economic effects which would emanate from such a tax will be uniformly detrimental to the interests of the bus industry. Second, the passage of such legislation would be contradictory to estblished energy policy. Finally, the tax would have a highly adverse effect upon our consumers, many of whom fall into economically disadvantaged classifications.

The American Bus Association is the national trade association for the intercity bus industry. With a fleet of some 21,000 buses, the industry transported 380,000,000 passengers in 1982. ABA has a membership of nearly 3,000. This includes bus operators and others engaged in travel and tourism, an industry that contributes $140 billion annually to our national economy. The travel industry has become increasingly dependent upon economical and energy efficient bus service.

We do appreciate the difficulties that Congress faces in its attempt to bridge the budget gap. It is in everyone's best interest that a better balance be struck between revenues and expenditures. But in the attempt to achieve this, Congress should not act in a fashion that would have a deleterious impact on an efficiently operating industry. A per barrel tax on imported oil would have this undesirable effect, not only in terms of the bus industry, but it could lead to a construction of travel and tourism as well.

If such a tax were imposed, bus operators will be forced to absorb the majority of the increase in fuel prices. Only a portion of the tax could be passed on to our passengers. The profit margin in our industry is already small and an additional levy will cut it still further. In 1981, the intercity bus industry net income was approximately $100,000,000 but in 1982 it was only half that amount. If our costs are pushed higher, many marginal and small bus operators could be forced out of the business, or see their productivity evaporate.

The intercity bus industry has been able to survive as a private sector provider of essential transportation services in the face of substantial subsidies to competing modes of transportation. An increase in our operating costs could have consequences for many small communities which have no other transportation service. If our service level were reduced, it could well lead to a more costly public system.

In Section 233 of the Energy Tax Act of 1978, Congress repealed the excise tax on diesel fuel used in buses providing intercity and local services to the general public and to buses used in charter or special service having a seating capacity of 20 adults or more. Two years later, Congress passed Section 222 of the Crude Oil Windfall Proft Tax Act of 1980 allowing an energy investment tax credit to qualified intercity buses. Both pieces of legislation were enacted in recognition of the necessity to conserve fuel and to maintain a viable intercity bus industry as a practical alternative to the private automobile. The case for repeal of the excise tax on the fuel in summarized as follows by the House Ways and Means Committee report on the Energy Tax Act of 1978:

"Since bus transportation is more energy efficient than private automobile transportation, the Committee believes it is desirable to encourage the greater use of bus transportation." [1]

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[1] Report of the House Ways and Means Committee on the Energy Tax Act of 1978, H. Rept. 95-496, p. 68.

In light of the foregoing statements, it is evident that Congress has followed a sound policy of encouraging bus ridership. An oil import fee would not be consistent with these policies.

The final point which we wish to make is that any cost increase which bus operators may encounter will, to some degree, be passed along to our riders. To the extent that the tax could be included in the price of bus tickets, it would be paid, in the main, by passengers over the age of 65, under the age of 21, and by those having incomes of less than $10,000 a year. These people consitute a majority of our riders.

From this perspective, it is obvious that this tax is regressive in nature. Our riders cannot afford an increase in their travel costs. Moreover, petroleum is already heavily taxes—in some states at the equivalent of 18 percent of value in the form of federal and state taxes. Our operator members have no option to shift to other fuels and must use petroleum regardless of the cost.

While the American Bus Association recognizes the need for additional federal revenues, an oil import tax is too narrowly based falling disproportionately on elderly and low income groups. Taxes for general public purposes should have the widest possible base and should fall equitably among the taxpayers. If an energy tax is needed as part of a larger tax package, it should be fairly imposed on all energy sources. An oil import tax does not provide this equity.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

Farm Bureau is the nation's largest agricultural organization representing farmers and ranchers in 48 states and Puerto Rico. Our policy is the result of a comprehensive policy development program at the county, state, and national levels which involves the active participation of our producer members.

Over three million member families belong to the Farm Bureau. Their livelihood depends upon agriculture, but their interests extend to other areas such as taxation and budget. These issues effect the economic well-being of farmers and ranchers. For this reason, Farm Bureau is pleased to comment on the revenue increase proposals that were the subject of committee hearings on July 19th through the 22nd.

It is with great interest and amazement that Farm Bureau views the Administration's and the Congress' continuing attempts to reduce the deficit by increasing taxes. To emphasize farmers' and ranchers' opposition to balancing the federal budget by increased or new taxes, Farm Bureau launched in April a grassroots organizational effort, the "Tax Attack". Our Tax Attack has three major points: (1) Opposition to new taxes or the restriction of currently scheduled tax cuts through the tax freeze proposal announced by Chairman Rostenkowski earlier this year; (2) Support for income tax indexing scheduled to begin in January, 1985; and (3) Support for the July 1 individual income tax rate reduction. Fortunately, the effort to cap the July 1 tax cut failed. However, Farm Bureau continues to be concerned about the freeze proposal because it would adversely affect the estate tax changes enacted in the Economic Recovery Tax Act of 1981. We are also troubled by the proposed imposition of excise taxes on domestic and imported oil as well as Administration proposals to enact a surtax on corporate and individual income. For these reasons, Farm Bureau is pleased to comment on tax increase proposals designed to meet the reconciliation requirements contained in the First Concurrent Budget Resolution to produce $12 billion in additional revenue in FY 1984. These proposals are: (1) The Administration's contingency tax plan which would impose a $5.00 per barrel excise tax on domestic and imported oil and a surtax on individual and corporate income taxes, and (2) the Rostenkowski freeze proposal which would repeal all tax reductions scheduled to take effect after December 31, 1983.

EXCISE TAX ON DOMESTIC AND IMPORTED OIL

Farm Bureau opposes an excise tax on domestic and imported oil and other energy taxes to increase revenue in an effort to offset the growing federal budget deficit. America's farmers simply cannot afford the added burden of an excise tax on oil. Farmers are price takers, not price setters, when selling their comodities. Unlike some businesses, farmers cannot simply add production cost increases such as an energy tax onto the price of their products.

A new tax on imported or domestic oil would make the already critical farm income situation even worse. Depressed commodity prices and increased production costs have reduced net farm income for the last three years. A new tax would reduce income even further.

If a tax on imported oil were enacted, farmers in rural areas would have to pay a disproportionate share of the import fee. Almost 75 percent of the farm's rural fuel requirements are served by cooperative and independent refiners that rely upon foreign imports for the bulk of their crude oil feedstocks.

SURTAX ON INDIVIDUAL AND CORPORATE INCOME TAXES

In testimony presented earlier this year to the Senate Budget Committee, Secretary of the Treasury Donald Regan offered statistics that illustrate why a surtax on individual and corporate income tax rates should be opposed. Between fiscal 1981 and 1988, the Economic Recovery Tax Act will reduce taxes by $1.138 billion. The Secretary, however, pointed out that a substantial tax cut is needed to offset the equally substantial tax increases facing taxpayers between 1981 and 1988. He pointed out the increased taxes caused by the Tax Equity and Fiscal Responsibility Act of 1982, the gasoline tax, the inflation induced bracket creep tax, and higher Social Security Taxes. These tax increases amount to $1.061 billion. These have the effect of leaving taxpayers with a net tax cut of only $77 billion between 1981 and 1988. Farm Bureau believes that these statistics speak for themselves and provide adequate reason to oppose a surtax.

TAX FREEZE PROPOSAL

Farm Bureau considers the tax freeze proposal particularly detrimental to farm and ranch families because it would freeze the scheduled reduction in estate tax benefits. We commend Representative Daub's introduction of H. Res. 216 to express to the House that the estate tax changes made in the Economic Recovery Tax Act of 1981 should not be modified.

Farm Bureau has had a longtime interest and involvement in the federal estate and gift tax area because of its effect upon the well-being of the nation's farm and ranch families. Farm Bureau actively supported estate tax releif in the Tax Reform Act of 1976, the Revenue Act of 1978, the repeal of the carryover basis, and the Economic Recovery Tax Act of 1981 (ERTA). The continuing interest of our three million member families is reflected in the following policy which was adopted by the voting delegates of the member state Farm Bureau at the American Farm Bureau Federation's annual meeting in January, 1983:

Federal estate taxes

"We favor repeal of the federal estate tax and until this is accomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and to exempt property on which an estate tax has been paid within 15 years prior to the death of the second decedent."

Repeal of the federal estate tax is a long-term goal of Farm Bureau. Estate tax reform in 1976 and 1978 debatably eased the economic and administrative burdens associated with the estate tax. However, such reform provided no permanent remedy for the increasingly heavy taxation of farm estates where the value of the land had been highly inflated. A result of inflation was to subject many small and moderate-size estates to the estate tax. The $47,000 unified credit enacted in 1976 had become of little benefit to most farm and ranch estates. Special use valuation, which had been hailed as an answer to estate tax problems for agriculture, has become so entangled in the regulatory decisions of the Internal Revenue Service that some executors and heirs of estates have decided to forego its application entirely. Material participation requirements and valuation procedures were so restrictive they negated a law intended to benefit farms and other small businesses.

Fortunately, Congress responded to the call of America's farmers and ranchers in 1981 by enacting far reaching changes in estate and gift tax law. The Economic Recovery Tax Act of 1981 not only increased the estate tax credit, but reduced the estate tax rates and made important modifications in Section 2032A, special use valuation. The increase in the credit will eventually exempt estates valued up to $600,000 from the estate tax. This particular provision is considered a lifesaver for the heirs of many farmers and ranchers who otherwise could be faced with selling part of the estate to pay the taxes on it.

Against this background of favorable changes in estate laws, farmers and ranchers in 1983 are now threatened with the prospect of restrictions in the recently liberalized tax treatment of their estates. The conference agreement on the First Concurrent Budget Resolution, H. Con. Res. 91, calls for new tax revenues of $12 billion in fiscal year 1984, $15 billion in 1985, and $46 billion in 1986. Farmers can be certain that estate tax law is on the firing line as a potential source of revenue.

In February, 1983, the Congressional Budget Office (CBO) listed a freeze in current estate and gift tax law as a revenue raising option for Congress to consider during fiscal year 1984 budget deliberations. In its report, the CBO noted:

"Further expansion of the estate tax credit can be criticized on several grounds. According to 1979 data, only about 3.5 percent of those dying in 1979 at age 45 and over had estates valued at more than $250,000. Any extension of the credit thus applies to only a small percentage of very wealthy taxpayers."—Congressional Budget Office report on strategies for reducing the federal deficit. (Feb. 10, 1983, p. 314.)

The CBO or anyone who thinks that the scheduled expansion of the estate tax credit applies only to wealthy taxpayers has not spoken with any farmers recently. While the CBO states that estates of more than $250,000 belong to "very wealthy taxpayers," that assertion probably would be news to the farmer or rancher. A farmer whose land is worth $1,000 an acre would only need 250 acres to have an estate that large—the average U.S. farm is slightly over 400 acres. Inflation has pushed up the dollar value of property and has forced many estates into higher estate tax brackets. As a result, the federal government receives a larger portion of an estate in taxes. We need a unified credit equivalent to an effective exemption of $353,500 in today's dollars to just equal the $60,000 estate tax exemption of 1942. The average farm owner's equity in 1982 was $368,000.

The proposal to freeze the phased expansion of the estate tax credits is part of a tax freeze package proposed by Rep. Dan Rostenkowski, Chairman of the House Ways and Means Committee. This is an effort to use tax increases, rather than spending reductions, to lower the deficit. If enacted, the Rostenkowski proposal would freeze the current estate exemption at the 1983 level of $275,000 and the maximum tax rate at 60 percent, rather than allowing the exemption to increase to $600,000 by 1987 and the maximum rate to drop to 50 percent by 1985.

Farm Bureau opposes the freeze proposal. A freeze is in fact a tax increase and is an "invisible" way for Congress to repeal the ERTA provisions. It is ironic when one considers that during the tax debate of 1981, the House and Senate engaged in rather obvious competition to see which house could provide the biggest breaks in the estate tax laws. Farm Bureau supports the retention of the 1981 estate tax modifications. Farmers relied upon Congressional decisions in 1981 for the development of their personal estate plans. To freeze current law would wreak havoc with these plans. Farmers incur considerable costs in establishing estate plans. Each change in the law adds to these costs.

The freeze proposal is not a particularly effective way to raise revenues when estate taxes constituted only 1.3 percent of federal revenues in 1982. A freeze in the unified estate and gift tax credit at the 1983 level would produce approximately $6 billion between fiscal year 1984 and fiscal year 1988, while the freeze in rates at the 1983 level of 60 percent would produce increased revenues of $1.7 billion between fiscal year 1984 and fiscal year 1988. This amount may seem small in the context of the total revenue picture, but it is significant and at times devastating to individual farm heirs who must pay the tax.

The estate tax is a disincentive to savings, investment, and productivity. It is a tool of those who adhere to the philosophy of using tax policy to accomplish social goals, i.e., the redistribution of wealth. The size of farming operations often increases in order to maintain profitability in agriculture. Excessive estate tax levies can force the sale and splintering of this production base into units too small to efficiently or profitably produce food and fiber.

To penalize heirs for efforts of their decedents in establishing profitable businesses is fundamentally wrong in America's capitalistic private enterprise system. That notion is inconsistent with the emphasis on capital formation and the desire of many hard-working taxpayers to pass the fruits of their labor to their children and grandchildren.

Recent history shows that tax increases simply lead to higher growth rates in government spending, not lower deficits. The growth rate of federal spending must be reduced to erase the deficit and balance the budget. Otherwise, the economic recovery that has now begun cannot be sustained. It will be choked-off by additional taxes. We urge the Committee to reject the tax increases that are now being considered.

We appreciate the opportunity to offer our comments and ask that Farm Bureau's statement be included in the hearing record.

APPENDIX

While an estate tax freeze would raise insignificant revenues compared to total federal revenues, the impact on individual family farms and businesses can be substantial.

This table shows the effect of a freeze on taxable estates of $500,000 and $750,000.

EXAMPLES OF CURRENT LAW VERSUS A FREEZE ON ESTATE TAXES

	1983	1984	1985	1986	1987
$500,000 taxable estate:					
Gross tax	$155,800	$155,800	$155,800	$155,800	$155,800
Less credit	79,300	96,300	121,800	155,800	192,800
Nex tax (current law)	76,500	59,500	34,000	0	0
Net Tax (freeze)	76,500	76,500	76,500	76,500	76,500
Additional tax due to freeze	0	17,000	42,500	76,500	76,500
$750,000 taxable estate:					
Gross tax	248,300	248,300	248,300	248,300	248,300
Less credit	79,300	96,300	121,800	155,800	192,800
Net tax (current law)	169,000	152,000	126,500	92,500	55,500
Net tax (freeze)	169,000	169,000	169,000	169,000	169,000
Additional tax due to freeze	0	17,000	42,500	76,500	133,500

STATEMENT OF THE AMERICAN LAND DEVELOPMENT ASSOCIATION

INTRODUCTION

The American Land Development Association (ALDA) appreciates the opportunity to present its views to the Committee on proposed tax revisions designed to meet the revenue raising requirements of the First Concurrent Resolution of the Budget.

ALDA represents leading national and international companies which develop recreational, resort and residential real estate including vacation homes, condominiums, resort time-sharing, planned unit development, new and retirement communities and recreational vehicle parks and campgrounds. Our membership includes both real estate development subsidiaries of major corporations as well as privately held development companies.

TAX POLICY CONSIDERATIONS

Over the past few months, the news concerning the economy has been positive. Evidence indicates that the long awaited economic recovery is in progress. Leading the current recovery is the real estate industry which has begun to show significant improvement after an extended period of what amounts to a depression. The level of housing starts for June was 91.9 percent higher than the annual rate of 910,000 units reported in the same month a year ago. The level of building permits issued in June reached its highest level in 4½ years. Over the year ending in June, building permits were up 88.9 percent. With few exceptions, the gains were widely distributed across the nation in June. For the first six months of this year, housing starts have run at an annual rate of 1.7 million units. Investments in new homes surged 61.1 percent in the second quarter from the first. In contrast, the housing starts last year totalled 1.06 million units, the lowest level since 1946.

This improvement in the real estate industry is critical to the economic recovery because the industry is a significant component of the economy through its direct and indirect impact on output and employment. Increased starts and sales of housing brings with it increased sales of appliances, furniture, lamps, fixtures, yard supplies and equipment and other household items which in turn means jobs. In 1981, nearly 2.4 million people were employed in other industries to produce the products and services required by the real estate industry.

The performance of the industry, however, will depend on a number of factors. Among those factors exerting a significant influence on real estate investment activity and consequently on overall economic activity, are interest rates, marginal tax rates and the degree of uncertainty about existing tax provisions.

We are concerned about the recent upswing in interest rates and believe that interest rates are currently at a point which could stifle the improvement in real estate construction and sales and hence dampen the overall performance of the economic recovery. Short- and long-term interest rates have crept up over 1 percentage point since the beginning of May. Action by Congress on reducing the Federal deficit and on tax policy will be a significant determinant of interest rate changes. Failure of the Congress to address the outyear deficit means that the Federal government will need to engage in significant borrowing activity. Interest rates will be forced up as the Federal government competes with private borrowers for the available supply of funds. Thus, private sector investors will be crowded out of the credit market and be unable to obtain the funds necessary to proceed with investments in the real estate industry. Rising interest rates would most certainly bring real estate construction and sales to a grinding halt once again. The aborted economic recovery in late 1981 should provide an object lesson in key interrelationships between high interest rates, the curtailment of activity in the housing sector and the health of the economy.

Increased marginal tax rates on income from real estate will impede the recovery by raising the cost of capital. In general, the revenue raising tax provisions currently under discussion would result in significantly higher marginal tax rates on income from real estate and other types of investments. That is, the return investors would receive from additional investment would be lower due to the higher tax rate. This brings about a higher cost of capital, a disincentive to engage in further investments, and consequently a dampening effect upon the recovery. Certain of the tax proposals would tend to have disproportionate impact upon the real estate industry. Because investors look at the after tax return from the various investment alternatives, the effect of raising the tax rate on one form of investment is to lower its return relative to other available investments causing investors to shift funds from the less attractive to the more attractive investment.

Uncertainty in the minds of investors about deficits, interest rates and tax policy changes, will prevent them from making the long-term investment decisions critical to the economic health of this nation. That this is so stems precisely from the fact that investments in real estate tend to be much longer lived than investments in other forms of capital. Consequently, the sensitivity of real estate to any given change or any given degree of uncertainty will be much greater than sensitivity of investments in, for example, assets with only a three or five year life.

Because the real estate indusrry is a key component in the economy, we feel any adverse change to the industry will have a direct impact on the magnitude and duration of the recovery.

REVENUE OPTIONS

For all of these reasons, ALDA views with concern the many tax policy changes that have been under discussion as revenue raising measures, some of which would have direct impact on the industry.

Numerous changes were made to the tax laws in 1976 and 1978. Major changes were also made in 1981 and 1982 which had an impact on the industry. We believe too little time has elapsed since enactment of those recent acts to determine the full effect of those changes on the real estate industry. Consequently, we suggest a moratorium on further changes until such time as a careful assessment can be made of them. We are concerned that a mid-course correction to a key component of the economy could cause a reversal of gain achieved in the housing industry over the last several months.

Specifically we would oppose limiting consumer interest deductions as they relate to the time-sharing arrangements; limiting the home mortgage interest deduction, either as to number of homes or amount of deductible interest; imposing a separate tax on the sale of residential real estate; restricting the rehabilitation tax credit and lengthening the 15-year write-off period to 20 years.

With respect to the proposals to increase the write-off period from 15 to 20 years, we call to the Committee's attention a recent study completed by Coopers & Lybrand for the National Realty Committee. This study concludes that the increased write-off period would result in lower levels of investment as compared to retaining the 15-year write-off period. Furthermore, there would not be any revenue gain due to the reduced level of output and income resulting from this proposal.

One of the revenue raising measures receiving considerable attention is the broad-based tax. We recognize that a number of proposals are pending, including a proposal by Congressman Gephardt, to substitute a flat-tax or a near flat-tax for our present tax system. For individuals, the Gephardt bill provides for a progressive tax with three rates of 14 percent, 26 percent and 30 percent. For businesses, that bill would impose a tax rate of 30 percent, but would repeal most existing tax deductions credits and exemptions. Under the bill, structures would have a class life of 40 years and the regular investment tax credit, the credit for rehabilitation of buildings and the long-term capital gains provisions would be repealed. Other flat-tax bills use a similar approach.

Although ALDA has not had an opportunity to fully assess the impact of any such proposals, we fear that any flat-tax proposal which would reduce or repeal the existing home mortgage interest deduction, repeal capital gains, or lengthen the depreciation period would have a disproportionately adverse impact on real estate investments. Therefore, we would urge the Committee to move cautiously and carefully on the options of any flat-tax.

VACATION HOMES

Earlier, we stated our opposition to any limitations on home mortgage interest deductions as it relates to vacation homes. In our view, severe limitations have been made by the Congress on the use of vacation homes and additional limitations are not warranted at this time.

We would urge the Committee not to make any further changes with respect to vacation homes until such time as it has determined that abuses exist in that industry and that such abuses cannot be curbed by the Internal Revenue Service under existing rules and regulations.

While current studies are not available, past studies have clearly established the vacation home industry as a major industry in the United States and a key industry in many localities and states. Consequently, any substantial tax changes to this industry which has been struggling through the recent economic downturn could have a serious adverse impact on revenue and employment of numerous states and local governments. In addition, tax changes could rob many families of investment and a lifestyle which they have earned through hard work.

TIMESHARING

The timesharing concept is simple. It allows the timesharer to pay only for the time he/she uses the resort. Timesharing plans offer vacationers increments of time, usually one week per year. Timesharing programs may be classified either as ownership, or right-to-use. The ownership program offers the purchaser an actual fee simple interest in real property. Right-to-use plans sell licenses, leases or club memberships for a period of time, usually 30 to 40 years, after which possession of the property reverts to the developer/seller. Timesharing programs are usually purchased through the use of a 5-year mortgage and/or note with a 20 percent downpayment.

Timesharing is one of the fastest-growing nontechnological industries in America today. Close to 500,000 families now own timesharing properties in more than 800 resorts nationwide. Resorts and urban areas in more than half the states now offer timesharing units. Sales have risen from $50 million in 1975 to $1.3 billion in 1981.

The typical timesharing family has a median annual income of $37,500 and has between three and four children. The average age of the head of household is 46 years old and in nearly half of all timesharing units, both spouses are employed.

Timesharing generates local income. Studies have found that the average 1981 expenditure per timesharing visit was $540, and $433 for travel expenditures per visit. Studies have estimated that timesharers spend about $170 million annually in the communities where their units are located and in addition, about $136 million each year travelling to and from their timeshare.

To ensure buyer protection and the continued health of the maturing timeshare industry, the National Timesharing Council (NTC), the trade association representing companies which design, develop, or sell timesharing, developed a Model Timesharing Ownership Act in 1979. That act establishes industry regulations and consumer protection at the state level. The Council, with other groups worked with state legislatures to win adoption of the Act in several resort states. We are confident that through our continuing effort of working with other industry groups, and the state legislatures we can assure that abuses can be eliminated and that all timesharing participants will be protected.

For the information of the Committee, we have attached to our statement, a "State-by-State Review of Laws Regulating Timesharing."

Timesharing is one of the only ways for some taxpayers to share in the good times in America. Accordingly, we would urge the Committee not to place any limitations on the home mortgage interest deductions or on non-business interest deductions.

CONCLUSION

In conclusion, we believe the real estate industry, a key component in the economy, is leading the overall economic recovery. We also believe that adverse tax changes could severely dampen that recovery and yet produce little revenue to the Treasury.

Certainly and continuity are important to consumers and investors alike, especially for longer-lived assets. Additional significant tax changes at this time would tend to undermine their confidence resulting in serious damage to the recovering economy.

Finally, we agree with the Congress that the outyear deficits must be reduced to achieve a growing and prosperous economy. In lieu of changing the tax laws now, we favor a contingency tax similar to that advocated by the President. However, we do not necessarily agree with the imposition of an oil import fee or a surcharge on individuals and businesses. We would alternatively strongly urge the Congress to reexamine the spending side of the equation.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

SUMMARY

I. Petroleum industry profitability, capital expenditures, and taxes

A. Profitability.—(1) With falling demand and prices, the profits of U.S. oil companies have suffered. The 1982 profit figure of about $20 billion for leading U.S. oil companies is equivalent to $8 billion in 1968 dollars.

(2) The oil price increases of 1973–74 and 1979–80 only temporarily raised oil industry profitability above that of other industries. For 1982, the rate of return on oil company shareholder investment was 14 percent with no adjustment for inflation—in line with the industry's historic average.

B. Capital expenditures.—(1) The prospect of increased profitability provides the incentive for growth in oil industry capital spending and much of the cash and borrowing capacity to finance new investments. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits, and investment continued to climb through 1981.

(2) Increased capital expenditures led to more than a tripling of net additions to property, plant and equipment of the leading U.S. oil companies between 1974 and 1981—primarily for petroleum activities. The spending especially stimulated new oil production in non-OPEC countries. From 1974 to 1982, oil supply from non-OPEC, Free World countries rose almost 40 percent, and after a decade-long downward trend, U.S. production of crude oil has even been increased somewhat. However, as indicated in Chart III, decreasing profits have led to reductions in 1982 expenditures.

C. Tax burden.—In the face of receding demand and falling profits, the taxes paid by oil companies have remained high. The petroelum income tax burden alone for 1982 was comparable to that of other companies—19 percent. Windfall profit taxes raised that figure to 43 percent, well above the tax burden of other industries—exclusive of deferred income taxes which are high in industries (such as petroleum) that invest heavily in new plants and equipment, and state severance and property taxes. Federal legislation passed in 1982 placed an even greater tax burden on the oil industry and its customers. A Price Waterhouse study prepared for API estimated that six major provisions alone of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") will boost the taxes of 31 large oil companies by $11–15 billion during the 1983–1987 period. In addition, the 5 cent per gallon increase in the motor fuels excise tax, effective April, 1983, is expected to raise initially some $4–5 billion per year.

II. Energy taxes

A. General.—(1) All taxes—including energy taxes—will have a negative short-run economic impact which would tend to offset, to some degree, the federal deficit reduction anticipated from imposition of an energy tax.

(2) Several energy taxes have been proposed including: the Administration's contingent oil tax, an oil import fee and broad-based BTU or value-based energy taxes.

(3) Any energy taxes would create a competitive disadvantage for U.S. manufacturers, particularly "smokestack" industries competing with foreign manufacturers; tend to reduce overall efficiency in the economy; adversely affect individuals—directly by higher energy costs and indirectly by higher costs of goods; and tend to

shrink the market for petroleum products, causing further loss of jobs and facilities in the depressed refining and marketing sectors.

B. Administration's proposal.—(1) The Administration proposed a $5/barrel oil excise tax to take effect in fiscal year 1986 if certain conditions are met.

(2) Such a tax would raise substantially less *net* federal revenues than the gross revenue estimates of $25–$30 billion; create regional inequities in the per capita cost of energy; disadvantage U.S. refiners unless the proposal were extended to cover imported refined products; and create uncertainty in the marketplace (due to the "contingent" feature) which would affect the petroleum industry both in terms of investor confidence and decisions to make new investments.

C. Import fees and other energy taxes.—(1) Although an import fee is intended to stimulate domestic production as well as raise revenues, domestic producers would retain only a small portion of any price increase because of Windfall Profit Tax and other taxes.

(2) Import fee would tend to create regional inequities in per capita energy costs; create distortions in the fuel market from attempted fuel switching; create pressure for special exceptions for various oil users which could distort the efficiency of importation, create an awkward new set of government regulations, and result in higher prices for consumers; disadvantage U.S. refiners if imposed only on imported crude; and not be consistent with a free trade policy and could harm countries allied to the U.S.

(3) Under a BTU or value-based approach a broad-based excise tax would be imposed on most fuels.

(4) Either approach would result in substantial pyramiding of the tax unless a credit mechanism for energy consumed in producing energy were devised.

(5) A BTU tax would create market distortions among the various fuels because it would be based on energy content rather than price; create intra-fuel distortions based on quality differences (e.g., between high- and low-sulfur crude oil); and create distortions based on location of fuel.

III. Tax expenditures

A. In general.—(1) The Congressional Budget Act treats "tax expenditures" as revenue losses attributable to provisions of the Federal tax laws which deviate from the "normal" tax structure. One of the major problems with the "tax expenditure" concept is the lack of a precise definition of what constitutes this "normal structure." A second problem is that the "tax expenduture" concept suggests the government is spending money to achieve a special purpose, even though the real reason for a "tax expenditure" may be to reduce the effects of disincentives in the existing tax structure.

(2) Business "tax expenditures" often help to offset the bias in the existing income tax structure against savings and capital formation. Moreover, in the case of two tax provisions of importance to the oil and gas industry—the option to deduct intangible drilling and development costs currently and percentage depletion—"tax expenditures" have the desirable effect of improving the nation's energy security.

B. Intangible drilling and development costs

(1) The following chart summarizes the tax treatment of IDC's:

Corporations which are integrated oil companies	Corporations which are independent producers	Individuals
Currently deduct 85 percent of IDC's. Amortize 15 percent over 36 months—no ITC.	Currently deduct 100 percent of IDC's	Currently deduct 100 percent of IDC's. Tax preference item if currently deducted. May elect 5-year ACRS with 10 percent ITC if not a limited partner ship interest. May elect 10-year amortization.

(2) According to the Congressional Budget Office, computation of "tax expenditure" involves a comparison of the revenue raised under current law with the revenue that would be collected if the provision had never existed. If the IDC and percentage depletion "tax expenditures" had never existed, taxpayers would be recovering IDC's through the same methods of depreciation used for lease and well equipment, just as such costs are recovered under generally accepted accounting principles for financial statement purposes. For IDC's occurring in 1981 and later, the appropriate treatment is the same as that for tangible investment, five-year Accelerated Cost Recovery System recovery with the Investment Tax Credit. Even this

treatment would not have provided the full protection of expensing or an inflation adjustment during the 1970's. From a practical standpoint, there is no substitute for current expensing.

(3) From a practical standpoint, current expensing should be the "normal" recovery method, because it alone avoids the erosion in real value of capital cost recovery through inflation when deductions are spread over a period of years. In effect, the JCT staff recognizes this problem in their "Estimates of Federal Tax Expenditures for Fiscal Years 1983-1985," p. 5. Furthermore, since IDC expensing is a "timing tax expenditure," over the life of an oil and gas project, IDC expensing will not reduce the total taxes that will be paid on the income from that project; rather it only changes the time of payment of those taxes relative to the time of payment under alternative systems of capital recovery such as ADR or ACRS.

(4) The right to take a current deduction for IDC's, both because of its positive effect on the present value of the after-tax cost of an investment project and because of its positive contribution to current cash flow, helps to attract investment into oil and gas developments despite the high financial risk and costs. Further limitation of the right would cause withdrawal of significant amounts of capital. As a result, there would be less drilling, less oil produced, and commensurately lower tax receipts because of lower windfall profit and corporate income taxes.

C. Percentage depletion.—(1) Generally, depletion is a method of recovering capital invested in the extraction of oil, gas and certain other minerals with the largest such capital cost being acquisition of the right to extract the commodity. Two types of depletion are available: cost depletion and percentage depletion.

(2) Measuring the percentage depletion "tax expenditure" by comparing it to cost depletion as the "norm" is not economically justified. Cost depletion is one of the slowest methods of capital recovery. For a long-lived property, such as an oil or gas project therefore, it substantially decreases the present value of future cost deductions. It also does not account for the enormous amount of inflation experienced during the last decade.

(3) Unlike the manufacturing sector where technology developments often make replacement machinery and new investment more efficient at the original or even reduced cost, the petroleum industry faces ever higher costs and higher risks associated with finding new reserves. The only method which even begins to recognize the unique nature of this industry is one based on replacement cost of existing reserves.

(4) The current sales prices of proved reserves of oil are reported in the press to average about $7-8/barrel in the ground—equivalent to roughly ¼ of the average current wellhead price of oil. Thus, the rate of percentage depletion equivalent to 25 percent would be required to allow sufficient capital recovery to match the current replacement value of domestic reserves of oil and gas.

IV. Conclusion

In addressing the presently projected out-year budget deficits, Congress should first enact the promised further expenditure reductions, mindful of the potentially harmful effect taxes—especially hastily conceived taxes—can have on the economy. However, should subsequent economic conditions become clear and compel Congress to raise revenues, a tax meeting the following minimum standards would have the least adverse impact on the economy:

(1) Avoids penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the U.S. regardless of where produced while not increasing the cost of goods exported from the U.S.

(2) Is neutral in impact on individual competitors and industries with regard to choice of investments or consumption expenditures or form of organization.

(3) Does not sharply affect the distribution of the tax burden by being overly regressive or progressive.

(4) Avoids negative impact on incentives to save and invest.

STATEMENT

The First Budget Resolution calls for legislation to raise revenues of some $73 billion during fiscal years 1984 through 1986. A far preferable course of action would be enactment of further expenditure reductions, as was promised in September 1982. However, should Congress enact out-year revenue increases in 1983, such tax measures should refrain from targeting particular industries. To do so would distort resource allocation away from the higher-taxed industries in contravention of free consumer choice, and thus would increase inefficiencies in the economy. Any revenue increases should not discourage savings and the productivity-enhancing investment which is so vital to sustained economic growth and restored competitiveness of American firms in domestic and foreign markets.

A call for immediate action on tax increases has led to various specifgic energy tax proposals. This submission addresses such proposals in light of petrileum industry profitability, capital expenditures and tax burden.

I. Petroleum industry profitability, capital expenditures, and taxes

A. Current petroleum situation.—Oil consumption in both the U.S. and other industrialized OECD countries has fallen about 17 percent below its 1979 level; and in constant dollars, current Rotterdam crude oil spot prices are now about 35 percent below the heights reached during the 1979–80 oil crisis.

With falling oil demand and prices, the profits of U.S. oil companies have suffered. Among 22 major U.S. oil companies, 1982 earnings were almost 30 percent below the level in 1980. In constant dollars (GNP deflator), 1982 profits were down nearly 40 percent.

As a result of these price and profit setbacks, oil companies are reassessing and often reducing the scope of their operations especially when they involve high-cost energy from unconventional sources or frontier regions. For the first time since the early 1970's, the total capital expenditures of major U.S. oil companies turned down last year. While costly outlays on oil exploration and development proceeded at record high levels in 1982—some five time the 1972 spending level in current dollars—current and future investment plans are now being reevaluated and sometimes cut back. API's latest figures indicate that oil and natural gas well completions during the first quarter of 1983 declined 6.9 percent from the same period in 1982. Total drilling footage declined 15.5 percent, and exploratory well completions declined 11 percent from the year-earlier level. Since the first quarter of 1982, the number of operating drilling rigs has declined by more than 44 percent.

Such cutbacks in exploration and development are especially unfortunate at a time when the United States needs to continue reducing its dependence on foreign oil. Much progress has been made toward this goal over the past few years. U.S. petroleum imports in 1982 continued their downward trend, averaging 5 million barrels per day—0.7 million barrels per day below the 1981 average and 43 percent under the peak level of 8.8 million barrels per day in 1977. Reductions in imports of OPEC petroleum have been particularly pronounced: from 6.2 million barreis per day in 1977 to only 2.1 million barrels per day in 1982. Thus, while the U.S. depended upon OPEC countries for about 70 percent of all petroleum imports as recently as 1977, the dependency was down to 42 percent by 1982 (15 percent of total demand).

A key reason for the reduction in U.S. oil import dependence is the elimination of U.S. oil price controls which had prevented U.S. oil prices from rising to world levels. Energy users responded to higher prices by buying less oil. And domestic oil producers responded with record levels of investment in oil exploration and production.

The pay-off from such investment has been the stabilization of domestic oil production following a long period of decline. U.S. output of crude oil in 1982 was up and estimated 700,000 barrels a day over what it would have been had oil price decontrol not occured. And were it not for the so-called "windfall profit" tax that accompanied decontrol, it is estimated that production would have been even higher—some 1.5 to 2.0 million barrels a day higher by the late 1980's. A level of 1.5 to 2.0 millon barrels a day would amount to about one fourth of U.S. oil imports of some 7–8 milion barrels a day expected by the Energy Information Administration in the late 1980's.[1]

B. Oil industry profits and profitability.—Chart I shows worldwide profits of leading U.S. oil companies for the period 1968–1982 in both current and constant dollars. When the real buying power of a proft dollar is considered, the 1982 profit figure of about $20 billion is equivalent to $8 billion in 1968 dollars. This adjustment for inflation is conservative since it is based on the implicit price deflator for U.S. gross national product, which has risen much less rapidly than the cost of oil exploration and production since the early 1970's. For example, the U.S. producer price index for oil field and gas field machinery rose 1.7 times as much as the U.S. GNP deflator from 1972–1982. Worldwide exploration and production expenditures account for about two thirds of petroleum capital outlays.

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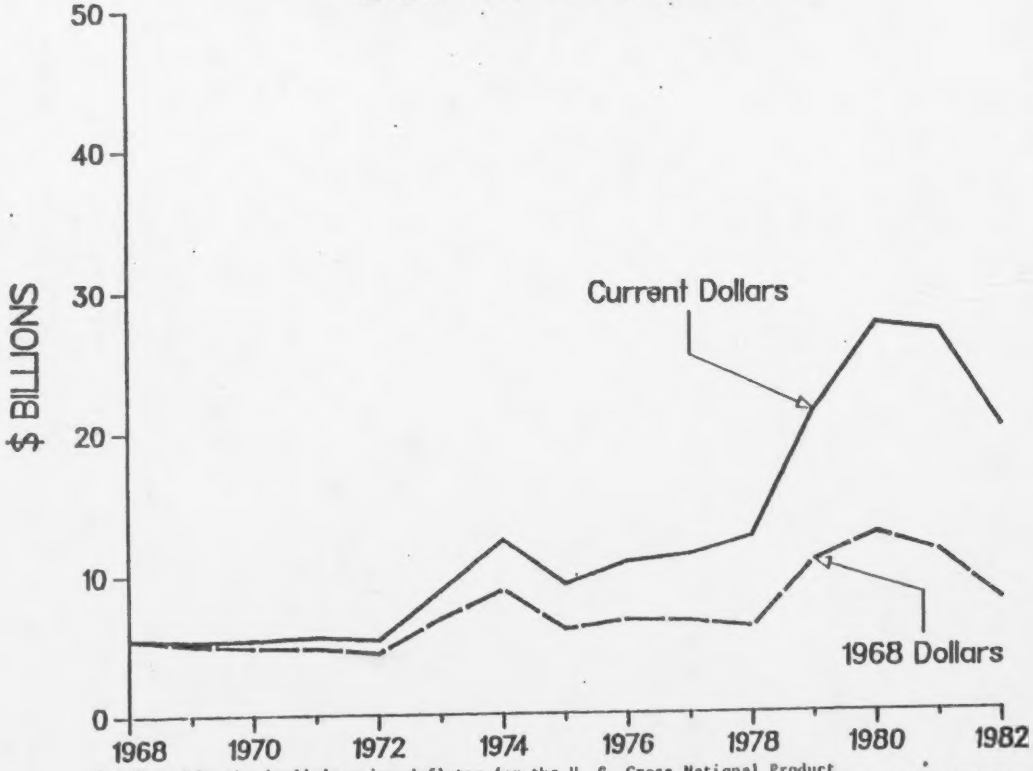
[1] Energy Information Administration, "1982 Annual Energy Outlook With Projections to 1990," (April 1983).

CHART I

WORLDWIDE PROFITS OF 22 U.S. OIL COMPANIES, 1968–1982 AS REPORTED IN CURRENT DOLLARS VS. BUYING POWER MEASURED IN CONSTANT 1968 DOLLARS*



* Deflated by the implicit price deflator for the U. S. Gross National Product
Source: American Petroleum Institute, 1981 data are preliminary from Financial Reporting System, based on 1982 EIA Annual Energy Review

In view of the unusually high financial risks of petroleum exploration and development, one would expect petroleum industry profitability consistently to exceed average profitability in other industries. However, in only seven of the last fifteen years has oil company profitability exceeded the average profitability of non-oil manufacturing companies by more than a percentage point. (See Chart II).[2] Four of these (1970, 1975, 1981 and 1982) were recession years when oil profits normally hold up better than profits in more cyclical industries such as steel and automobiles. The oil price increases of 1973-1974 and 1979-1980 only temporarily raised oil industry profitability above other industries. During 1976-1978, oil returns were below non-oil manufacturing returns; and, while oil company returns have remained above non-oil company returns from 1979-1982, the difference has narrowed greatly since 1980. For 1982, the rate of return on oil company shareholder investment was about 14 percent with no adjustment for inflation—in line with the industry's historic average.

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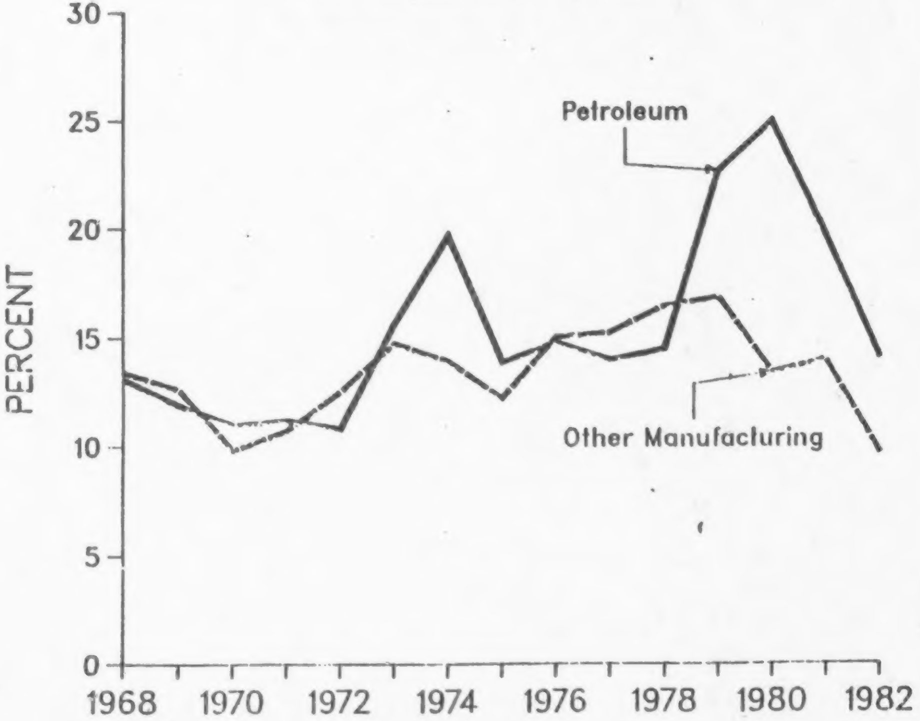
[2] According to Citibank data on worldwide net income as a percent of shareholders' equity.

CHART II

WORLDWIDE RETURN ON SHAREHOLDER EQUITY, 1968–1982
U.S. OIL COMPANIES VS. OTHER MANUFACTURING
not adjusted for inflation



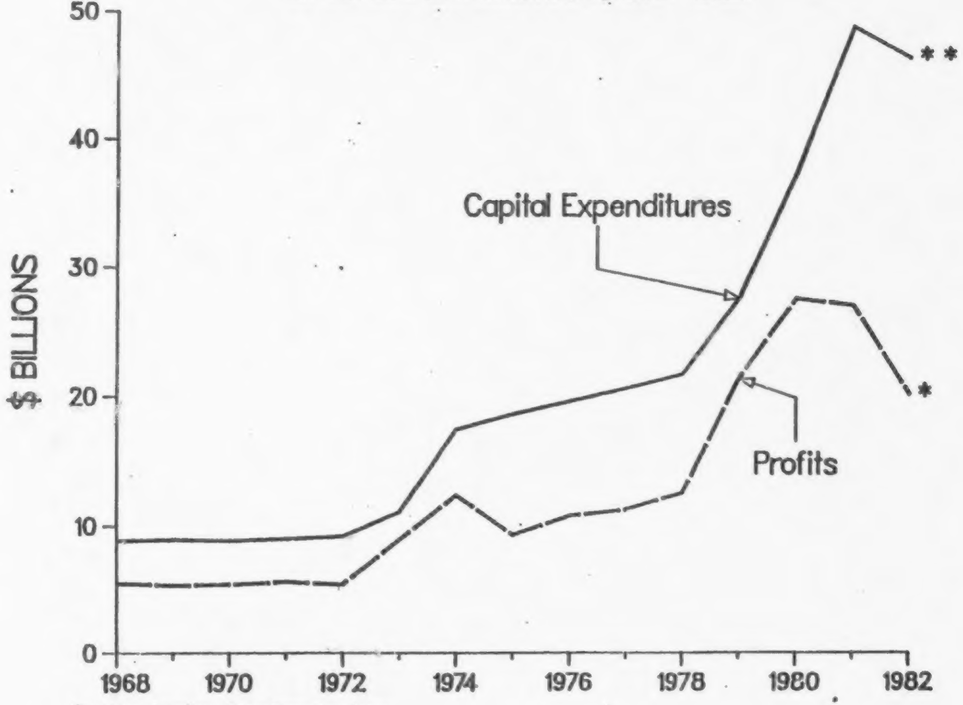
Source: Citibank Economic Week, April Issues

C. Capital expenditures.—The prospect of increased profitability provides the incentive for growth in oil industry capital spending. Profits also provide much of the cash and borrowing capacity required to finance new investments. As Chart III shows, capital expenditures move closely with profits, but there is a lag because of commitments already made on projects having relatively long lead times.

While profits were about constant during 1968–1972, capital expenditures were also constant. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits. The average level of profits during 1974–78 was also about twice the 1968–1972 level.

CHART 5

WORLDWIDE PROFITS AND CAPITAL EXPENDITURES
OF 22 U.S. OIL COMPANIES, 1968–1982



Source: American Petroleum Institute
* 1982 profit figures, preliminary
** 1982 expenditure figures, estimates

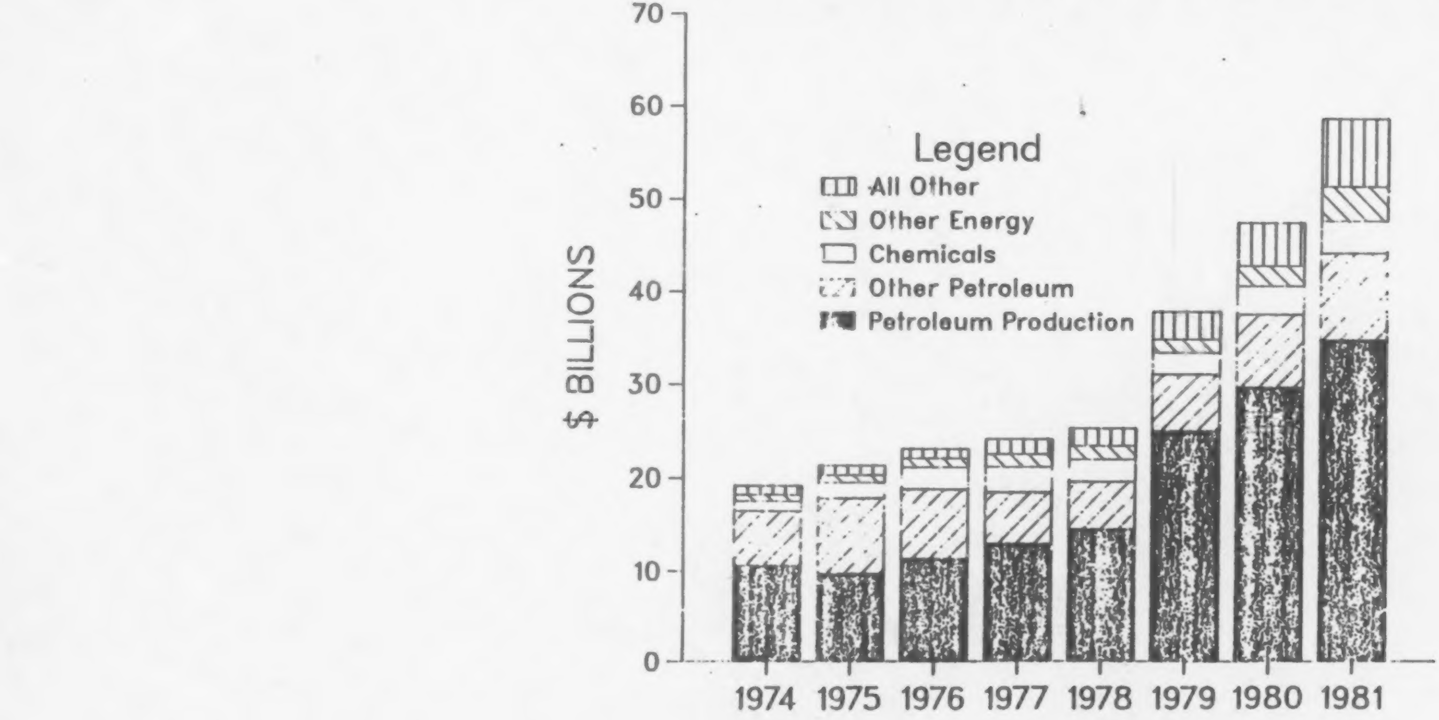
	Profits	Capital Expenditures
	-------Billion	Dollars-------
1968-72 Average	$5	$9
	+6	+11
1974-78 Average	11	20
	+16	+23
1980-81 Average	27	43
	-7	+3
1982	20	46

By 1980-1981, profits were up by another $16 billion and capital expenditures were up by $23 billion. The larger absolute increase in capital expenditures was made possible by rising profits. Even though 1982 profits were some $7 billion lower than the 1980-1981 average, capital expenditures were still $3 billion higher because of the lag created by committed investments in long lead time projects. And, comparing 1982 with 1981 alone, although 1982 expenditures were six percent lower ($46 billion versus $49 billion), they still fell less than the 25 percent drop in profits ($20 billion versus $27 billion).

The increased capital expenditure noted above led to more than a tripling of net additions to property, plant and equipment of the leading U.S. oil companies between 1974 and 1981. And, as Chart IV illustrates, the additions were primarily for petroleum activities. The spending has especially stimulated new oil production in non-OPEC countries. From 1974 to 1982, oil supply from non-OPEC, Free World countries rose almost 40 percent. Production of crude oil has even been increased somewhat in the United States after a decade-long downward trend. The welcome result has been a sizable reduction in OPEC's share of total Free World oil production—from 64 percent in 1974 to 44 percent in 1982.

CHART IV

WORLDWIDE ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT OF 26 U.S. OIL COMPANIES



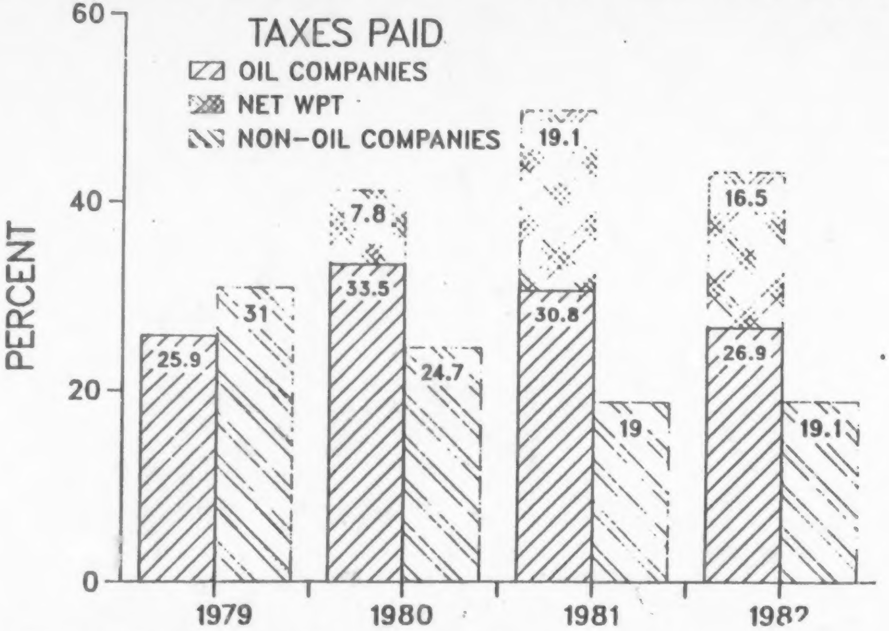
Source: Energy Information Administration, U.S. Dept. of Energy

D. Tax burden.—In the face of receding demand and falling profits, the tax burden of U.S. oil companies has remained high. While the petroleum industry's current federal income tax liability is comparable to the all-industry average, Windfall Profit Tax ("WPT") collections bring it well above the tax burden of other industries. The effect of the WPT in combination with other federal taxes, state taxes, and other payments to governments is to capture about 80 cents of each additional dollar of oil company revenue from U.S. oil price decontrol.

Chart V compares the current federal tax burden of leading U.S. oil and non-oil industrial companies from 1979 through 1982. For oil companies, the total federal tax burden is computed as the sum of current federal income taxes plus the WPT divided by income before such taxes. This burden increased from 26 percent in 1979 to 41 percent in 1980, 50 percent in 1981 and then, with falling crude prices, declined to 43 percent in 1982. The federal income tax rate shown for oil companies in Chart V is what would have been paid without the WPT. Since the WPT is deducted from oil company income, and income tax is levied on the residue, the effective income tax rate of oil companies is higher than the actual ratio of federal income tax payments to income after payment of the WPT. This latter ratio was roughly 31 percent in 1980, 23 percent in 1981 and 19 percent in 1982. Deferred federal income tax liabilities (which arise primarily from the difference between accelerated and economic-life cost recovery) are excluded from the calculated tax burdens.

CHART V

COMPARATIVE FEDERAL TAX BURDEN OF LEADING U.S. OIL AND NON–OIL INDUSTRIAL COMPANIES



Source: Corporate
Annual Reports
to Stockholders

1979: 23 Oil Companies and 86 Non–oil Companies
1980–1982: 20 Oil Companies and 75 Non–oil Companies

Note: Oil income taxes shown for 1980–1982 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computation procedure, the WPT is deducted from income; and income tax is levied on the residual. If there were no WPT, the income tax would be higher ––as shown above.

These data also ignore the fact that state and local governments usually tax U.S. oil producers more heavily than other kinds of companies. In particular, these figures exclude the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers.

Federal legislation passed in 1982 placed an even greater tax burden on the oil industry and its customers. The petroleum industry will pay a large share of the taxes collected under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). According to a Price Waterhouse study prepared for the API, six major provisions of TEFRA alone will boost the taxes of 31 large oil companies by an estimated $11–15 billion during the 1983–1987 period. In addition, the five cent per gallon increase in the motor fuels excise tax which went into effect on April 1, 1983 is expected to raise initially some $4–5 billion in federal revenue per year.

Even though the oil industry's tax burden is much higher than the average for other industries, some have suggested additional levies on oil producers. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. As a result, oil companies would be further constrained in their efforts to find and develop new energy supplies. Such a reduction would jeopardize the progress made in recent years to reduce the world's dependence on OPEC oil.

While oil demand has dropped sharply in recent years and may continue to drop in the years ahead, it is dangerously premature to conclude that U.S. energy problems have ended. Imports still account for about one fourth of U.S. crude oil requirements, and OPEC still controls about 76 percent of Free World oil reserves. A recent General Accounting Office study has noted that the probability of oil supply disruptions remains high and our nation remains vulnerable to periodic shortages.[3] The success that oil companies have had in reversing the decline in U.S. oil production and diversifying oil supplies worldwide ought not be undone through the imposition of new taxes.

II. Energy taxes

A. General.—All taxes—including energy taxes—will have a negative short-run economic impact. The Consumer Price Index and hence inflation, Gross National Product growth (output) and employment will all be adversely impacted by enactment of an energy tax. The short-run "feedback-effects" due to lower economic activity would tend to offset, to some degree, the anticipated federal deficit reduction amounts. Moreover, the accompanying higher energy prices could very well reverse the deficit-improving stimulus of the recent lower oil prices. Indeed, the recent decline in oil prices has been a significant factor in the economic recovery.

Imposing an energy tax would also create a competitive disadvantage for U.S. manufacturers both domestically and internationally. Unlike the 1970's oil price shocks, a unilateral energy tax will hurt only U.S. industries. Those traditional heavy or "smokestack" industries such as steel, which are still reeling from the recent recession, are likely to be harmed more by an energy tax than by other forms of taxes. There would also be a disproportionate negative impact on domestic auto sales and auto industry suppliers. Other energy-dependent industries such as agriculture, petrochemical, and aluminum would have lower capacity utilization, higher production costs and more unemployment.

An energy tax would also tend to reduce overall economic efficiency. Energy-using industries would tend to substitute other resources for higher cost energy, but this would result in a less productive mix of inputs and lower national output.

Individuals would also be adversely affected by the imposition of an energy tax both directly and indirectly. A tax such as the Administration has proposed would raise the price to consumers of energy with no corresponding offset to their disposable incomes. Thus an energy tax would tend to have the same effect as increasing personal income taxes. Individuals would also be indirectly affected by higher product prices due to businesses' increased production costs. These increased costs then fuel inflation.

As noted earlier, the situation in the petroleum industry today is dramatically different from that of just a few years ago. A new energy tax would tend to shrink the market for petroleum products, causing further losses of facilities and jobs in the refining and marketing sectors of the industry.

For each of these reasons, any tax increase which singles out energy will have a discriminatory impact on a number of key sectors of the U.S. economy. This is neither equitable nor efficient.

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[3] "Oil Supply Disruptions: Their price and Economic Effects." General Accounting Office Report to the House Committee on Energy and Commerce, May 20, 1983.

B. Administration's proposal.—Earlier this year, the Administration proposed a $5/barrel oil excise tax to take effect in fiscal year 1986 if the following three conditions are met in mid-1985:

(1) The economy is expanding;

(2) The fiscal 1986 deficit is projected to exceed 2.5 percent of the gross national product; and,

(3) Congress has previously agreed to the Administration's proposed spending constraints.

Assuming that annual domestic oil consumption in 1986 and beyond will be approximately 5-6 billion barrels, the proposed $5/barrel tax would gross $25-$30 billion/year. However, the tax would raise net federal revenues by substantially less, because consumers would spend less on other products. Thus, federal tax collections other than the oil tax would decrease; and this reduction would partially offset the revenues raised by the oil taxes.

The Administration's proposal would create regional inequities in the per capita cost of energy. Those sections of the country most heavily dependent on crude oil and its products for heating and transportation would bear more of the tax burden than other areas. Finally, unless the proposal were extended to cover imported products, U.S. refiners would be disadvantaged compared to foreign competitors who could send their products into the United States free of the cost of this tax.

The "contingent" feature of the proposal is particularly troublesome because it would tend to create uncertainty in the market place. This uncertainty would affect the petroleum industry both in terms of investor confidence in the industry and in the industry's decisions to make new investments, particularly with regard to long lead-time projects.

C. Import fees.—It has been suggested an oil import fee is one method to raise Federal revenues and to stimulate domestic production. However, as the Independent Petroleum Association of America recently noted, domestic producers would retain only a small portion of any price increase for domestic crude which might occur due to a price increase in imported crude primarily because of the impact of the Windfall Profit Tax. State severance and other taxes imposed on the domestic petroleum industry would reduce the amount available to the producer even more.

As with the Administration's proposal, an import fee would tend to create regional inequities in per capita energy costs. It would also be likely to create distortions in the fuel market as users attempt to switch fuels, particularly with regard to natural gas.

Another difficulty with an import fee is that U.S. refiners heavily dependent on imported oil perceive that they would be disadvantaged. Thus, there would undoubtedly be pressure for special exceptions to such a measure. The history of the Mandatory Oil Import Program in the 1960's and the price and allocation control programs of the 1970's demonstrates that requests for special treatment and exemption may well be granted to various classes of oil users. Accommodating these demands would distort the efficiency with which oil is imported, create an awkward new set of governmental regulations and likely result in higher oil prices for consumers. Additionally, a fee imposed only on imported crude oil would tend to disadvantage U.S. refiners in competition with foreign refiners who could sell their untaxed, finished products in the United States.

Furthermore, an import fee would not be consistent with a policy of free trade and could harm certain countries allied to the U.S. A sizable portion of U.S. oil imports comes from neighbors and allies such as the United Kingdom, Mexico, Canada and Venezuela. The U.S. is committed to reducing, not increasing, trade barriers under the General Agreement on Tariffs and Trade (GATT). A U.S. fee on oil might encourage retaliatory action on other traded goods.

D. BTU tax.—Under this proposal, a broad-based excise tax would be imposed on most fuels (domestic and imported oil, natural gas, coal, nuclear energy and electric power) based on energy content (BTU's). One of the major drawbacks to this proposal, in addition to the general negative features discussed earlier, is its tendency to create market distortion among the various fuels because it would be based on energy content rather than price. For example, low-price, controlled natural gas would beat a disproportionately large amount of tax relative to its price. Additionally, such a tax would create intra-fuel distortions based on quality differences. For example, there would be price distortions due to the tax among anthracite, bituminous and lignite coal or between high and low-sulfur crude oil. Substantial pyramiding of the tax would also occur unless some sort of credit mechanism for energy consumed in producing other energy were devised.

E. Value-based tax.—This mechanism is sometimes suggested as the alternative to the BTU tax because this method authomatically accounts for inherent differences in value attributable to the variations in BTU content and quality or location differences. As with the BTU tax, a broadly based excise tax would be imposed on most fuels. The value approach would avoid creation of new market distortions. However, the same risk of pyramiding (i.e., imposing a tax on energy used to produce other energy) which occurs with the BTU tax is inherent in this method, and some credit or refund mechanism to avoid the build-up of taxes is critical. The same general features of an energy tax noted in the first section—reduced GNP, increased inflation, harm to U.S. industries' competitive position in foreign and domestic markets, increased costs to consumers, etc.—apply to this tax proposal as well as all the others discussed herein.

III. Tax expenditures

Some have suggested that new revenues should be generated by eliminating certain so-called "tax expenditures." Two of these items—treatment of intangible drilling and development costs ("IDC's") and percentage depletion—are of particular interest to the petroleum industry.

The Congressional Budget Act defines "tax expenditures" as "* * * those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, or preferential rate of tax or a deferral of tax liability." The Administration in its 1984 budget, the Joint Committee on Taxation ("JCT") and the Congressional Budget Office ("CBO") all consider intangible drilling and development costs ("IDC's") and percentage depletion to be tax expenditures because, in the view of each of these entities, the IDC and percentage depletion treatment departs from the "normal structure" for corporate income taxation.

Such classification of these two items ignores one of the major problems with the "tax expenditure" concept: the lack of a precise definition of what constitutes the "normal structure". In particular, the Administration considers the Accelerated Cost Recovery System ("ACRS") the norm for depreciation while the JCT considers the "guidelines" method of depreciation to be the norm. Many economists would consider current expensing to be the norm. The concept of the "normal structure" being the "basic structural features of the Federal income tax" [4] is thus quite vague and subject to inconsistent interpretation and application.

Another problem with the concept of "tax expenditure" is that it suggests that the government is spending money to subsidize a special activity or achieve a special purpose, even though the real reason for a "tax expenditure" may be to reduce disincentives in the existing tax structure. This is particularly the case with so-called "tax expenditures," such as the dividend exclusion, which actually have the effect of ameliorating the double taxation of corporate income. Moreover, all existing taxes adversely affect economic incentives to some degree. It is therefore sometimes necessary to provide other specialized tax provisions to offset these tax effects if they are particularly strong with respect to some kinds of activities or industries. For example, since the corporate income tax—a tax on the income from capital—falls heavily on capital-intensive industries, an investment tax credit is justified to stimulate the modernization necessary for U.S. industry to compete more effectively in markets at home and abroad.

Given these considerable difficulties, Congress should be extremely cautious in attempting to cut back on deficits by trimming "taxing expenditures." Business "tax expenditures," in particular, often help to offset the bias in the existing income tax structure against savings and capital formation. Moreover, in the case of two tax provisions of importance to the oil and gas industry—the option to deduct intangible drilling and development costs currently and percentage depletion—"tax expenditures" have the desirable effect of improving the nation's energy security.

A. Intangible drilling and development costs—Background.—IDC's are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. § 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

For income tax purposes, IDC's are capital in nature and, as such, would ordinarily be taken into account through allowances for depreciation. Under section 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDC's for oil and gas wells and wells drilled for geothermal deposits. Only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. At the same time, the costs of all tangible equipment used in drilling and development activities are capitalized and recovered through depreciation.

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[4] The Budget for Fiscal Year of 1984, Special Analysis G at G-1.

Section 291(b), which was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, reduces the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period beginning with the month in which the costs are paid or incurred Sec. 291(b)(2)(A). These amounts are not eligible for investment tax credit and are also subject to recapture on later disposition of the property under Sec. 1254. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in IDC's using the five year ACRS schedule with the ITC, beginning in the year the property was placed in service. This is the same treatment afforded tangible well equipment, and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation, etc. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC.

Corporations which are nonintegrated oil companies are allowed to deduct currently 100 percent of their IDC expenditures. Similarly, all individuals are allowed to elect to deduct currently 100 percent of their IDC expenditures. However, if an individual elects to deduct the full amount, he must include the amount of "excess intangible drilling and development costs" in determining tax preferences for purposes of the alternative minimum tax. Treatment as a preference item can be avoided if the individual elects to deduct the costs under a five-year schedule similar to ACRS and claim ITC under Sec. 58(i)(4); or ratably over a ten-year period under Sec. 58(i)(1).

The following chart summarizes the tax treatment of IDC's:

Corporations which are integrated oil companies	Corporations which are independent producers	Individuals
Currently deduct 85 percent of IDC's. Amortize 15 percent over 36 months—no ITC.	Currently deduct 100 percent of IDC's	Currently deduct 100 percent of IDC's. Tax preference item if currently deducted. May elect 5-year ACRS with ITC if not a limited partnership interest. May elect 10-year amortization.

B. Measurement of the IDC "tax expenditure".—According to the Congressional Budget Office, computation of a "tax expenditure" involves a comparison of revenue collected udner current law with what would be collected in the absence of a specified provision: "The revenue loss from each individual tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed.[5]

Thus, in order to compute an IDC "tax expenditure," it is necessary to determine what the tax treatment would have been in the absence of the option to deduct IDC's currently.

This task is not easy because there has never been a period in U.S. tax history when taxpayers were completely denied the option to deduct IDC's currently to serve as the standard. Thus, although no specific statutory authority existed for the deduction of IDC's until 1954, the election was first confirmed by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows: "The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense."

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[5] CBO, "Tax Expenditures: Budget Control Options and Five-Year Projections for Fiscal Years 1983-1987" (November 1982), p. 21.

The tax treatment of IDC's was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. Although accounting practices may have changed over the years, the policy to develop domestic oil and gas resources still supports the need for rapid recovery of IDC's for tax purposes. Indeed, financial risks have escalated as industry must more frequently drill in high-cost, hostile offshore and frontier environments.

If current expensing of IDC's had never been permitted, the conceptually proper method for recoverying these costs over time would have been to treat them as part of the depreciable investment in lease and well facilities like the items of tangible well investment are treated today. The current treatment of capitalized IDC's as a depletable investment under Treasury Regulations § 1.612-4(b) is not based on sound tax accounting theory but on a questionable IRS interpretation of the discovery value depletion provisions of the Revenue Act of 1918. With the advent of discovery value depletion in 1918, the IRS changed its position announced in T.D. 2447 and contended that the depletable value of the well included capitalized IDC's except to the extent they were represented by physical property which was still considered depreciable. (Regulations 45, Art. 223.) The IRS continued to take the same position after percentage depletion was substituted for discovery value depletion in 1926. (Treas. Reg. § 1.612-4(b)—current regulations.)

With repeal of percentage depletion on most production, there clearly is no basis for continuing to characterize any portion of IDC's as depletable investment. In any event, if the IDC and depletion "tax expenditures" had never existed, taxpayers would be recovering IDC's through the same methods of depreciation used for lease and well equipment, just as such costs are recovered under generally accepted accounting principles for financial statement purposes. (See Financial Accounting Standards Board Statement No. 19, paragraph 35.)

For the years 1971 through 1980, the proper treatment for tax purposes in the absence of expensing would have been to recover IDC's through depreciation under 11 year Asset Depreciation Range ("ADR"), with the seven or ten percent ITC available. Exhibit A illustrates the amount of IDC expenditures in current dollars and as adjusted for inflation and "tax expenditures" under various criteria for each year from 1971 through 1980, the years ADR was in effect, for the API-Price Waterhouse survey group of companies. Exhibit A assumes that ADR plus investment tax credit was in effect for years prior to 1971 for purposes of illustration.

Exhibit A illustrates several points:

(1) assuming a consistent methodology of recovery, a constant level of investment expenditures for the preceding investment cycle and no pre-1971 inflation, as is the case in the computation for 1971, there is no tax expenditure that year because the amount deducted using ADR is the same as that deducted using current expensing. Additionally, had IDC's been capitalized as depreciable, producers would have enjoyed the full benefit intended under the investment tax credit provisions for the 1971 expenditures;

(2) excluding ITC, more than 85 percent of the apparent "tax expenditures" indicated in Exhibit A for years after 1971 is attributable to inflation. For years 1972 through 1980, there are apparent "tax expenditures" of $5,448 million compared to "tax expenditures" of $758 million if IDC's are adjusted for inflation;

(3) since the investment tax credit during these years by no means fully compensated for the erosion of inflation, it could not serve as the investment stimulus it was intended to be;

(4) when the investment tax credit is considered and the effects of inflation are eliminated, the IDC deduction results in greater real revenue to the government today than would have been the case with "normal" depreciable treatment—a "negative tax expenditure" of $143 million for 1972-80.

EXHIBIT A.—IDC TAX EXPENDITURE ANALYSIS

Year	IDC's		ITC [3] amount		"Tax expenditure" using criteria indicated (millions)			
					ADR-unadjusted		ADR-adjusted for inflation [1]	
	Unadjusted	Adjusted [1]	Undadjusted	Adjusted [1]	Without ITC [2]	With ITC	Without ITC	With ITC
1971	813	813	57	57	0	($57)	0	($57)
1972	874	801	61	56	$26	(35)	($5)	(61)
1973	912	772	64	54	38	(25)	(17)	(71)

EXHIBIT A.—IDC TAX EXPENDITURE ANALYSIS—Continued

Year	IDC's		ITC [3] amount		"Tax expenditure" using criteria indicated (millions)			
	Unadjusted	Adjusted [1]	Undadjusted	Adjusted [1]	ADR-unadjusted		ADR-adjusted for inflation [1]	
					Without ITC [2]	With ITC	Without ITC	With ITC
1974	1,271	836	89	59	188	99	14	(45)
1975	1,951	1,004	195	100	449	254	85	(15)
1976	2,354	1,107	235	111	542	307	114	3
1977	2,945	1,197	295	120	696	401	132	12
1978	3,335	1,121	334	112	727	394	73	(39)
1979	4,079	1,146	408	115	862	454	65	(50)
1980	7,047	1,741	705	174	1,920	1,215	297	123
1972–80	24,768	9,725	2,386	901	5,448	3,064	758	(143)

[1] Inflation adjustment is based on footage rate data in the "Joint Association Survey of the U.S. Oil and Gas Producing Industry," API.
[2] Yields essentially same result as JCT "tax expenditure" methodology.
[3] 7 percent 1971–74, 10 percent 1975–89.

Source: "Statistical Data for Selected Petroleum Companies Complied for Use in Analysis of Taxes and Effective Federal Income Tax Rates" by Price Waterhouse & Co. for the American Petroleum Institute.

For IDC's occurring in 1981 and later, the appropriate depreciation standard is the same as that for tangible investment, five-year ACRS with ITC. This method comports with the Administration's 1984 budget which states that the norm for determining tax expenditures is the Accelerated Cost Recovery System. Although the more rapid recovery limits erosion through inflation, even the combination of ACRS and ITC would not have provided the full protection of current expensing or an inflation adjustment during the 1970's. From a practical standpoint, there is no perfect substitute for current expensing, but in its absence, use of five-year ACRS with ITC avoids the complexity of an inflation adjustment and the controversy as to the proper index to be employed.

The staff of the JCT has focused attention on the inflation problem in its explanation of the tax expenditure concept in Estimates of Federal Tax Expenditures for Fiscal Years 1983–1988, March 7, 1983, at p. 5: "One of the problems with the staff's definition of the depreciation tax expenditure is that it neglects the effect of the inflation in eroding the real value of depreciation deductions. Even with accelerated depreciation, taxpayers will not always receive deductions whose real value corresponds to the amount they originally paid for the asset. A similar problem arises in the definition of the tax expenditure for capital gains. The staff is studying whether to alter the definitions of these and other tax expenditures to take account of the distortions caused by inflation."

In effect, the JCT staff acknowledges that any period of capital recovery longer than immediate expensing will result in deductions worth less than the original cost of the investment during a period of rising prices. Indeed, even in a period of stable prices, the present value of deferred capital recovery must be less than original value as long as money has a time value (i.e., there is a positive discount rate).

Aside from inflation and the question of which norm to use, the JCT staff's method endeavors to measure the expenditure "as if the provision had never existed" by using as the norm a ten-year recovery period (double declining balance, switch to straight line in year seven). Although not characterized as "depreciation," this method yields results quite similar to eleven-year double declining balance with a switch to sum-of-the-years-digits as used under ADR for tangible well investment (without ITC) and in the calculation in Exhibit A. Thus, a large portion of the JCT's estimate for the IDC's tax expenditure is attributable to inflation.

There will be no "tax expenditure" as defined by the JCT, even with IDC expensing, as long as there is no growth in IDC's either from inflation or real growth (i.e., a steady state system). For example, if IDC's or any other timing difference item were $100 every year, and ten-year straight-line amortization were the standard of "tax expenditure" calculation, after one ten-year cycle had been completed, the cost recovery deduction would be $100 per year—equal both to IDC expensing and to the sum of the $10-per year straight-line depreciation increments for each of the ten recovery years. If, however, there is growth in IDC's, adjusting for inflation leaves only increases attributable to real increases in IDC's which are desirable to secure a reasonably priced, secure source of petroleum for the future.

In contrast to this method is the CBO approach, for example, which appears to measure only the initial revenue effects of changing recovery methods, not the "expenditure" as if current expensing had never existed. This defect in methodology accounts for tax expenditure estimates which are unrealistically high by a factor of as much as three, as compared to the JCT method.

Viewed from a different perspective, the flaw in the measurement of any depreciation "tax expenditure" is that the very concept fails to acknowledge that over the life of a project, accelerated depreciation changes the time of payment of these taxes but does not reduce the total amount of taxes paid to the government. Hence, there is a zero tax expenditure for any given investment in its entirety. That is, IDC expensing does not reduce the total taxes that will be paid to the government on the income from an oil and gas project; rather it only defers the payment of these taxes relative to the time of payment under alternative systems of capital recovery such as ADR or ACRS.

Even though IDC "tax expenditures" must be small or nonexistent from a government perspective if properly measured, the election to expense IDC's is vital to oil and gas investors both because of its positive effect on the present value of the after-tax cost of an investment project (relative to its present value with ADR or ACRS depreciation) and because of its positive contribution to current cash flow. The right to take a current deduction for IDC's substantially improves the financial attractiveness of oil and gas exploration and production relative to recovery over time. Costs recovered in the present are less burdensome than costs recovered in the future, especially in a period of high inflation and interest rates. Moreover, many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to absorb the additional costs which would be caused by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

Exhibit B presents the present value of recovery allowances and the ITC for a dollar of IDC's under various recovery methods. Current expensing, of course, provides full recovery of capital values regardless of the discount rates used or the amount of inflation assumed. The present five-year ACRS with ITC under either the ten percent with basis adjustment approach or eight percent without basis adjustment yields comparable present value recovery at a ten percent discount rate, but falls short at the higher rates required in petroleum exploration and production. Other methods miss the mark by even wider margins. For example, if the TEFRA 36-month amortization treatment were extended to 100 percent of IDC investment, the present value gap would be considerably more than even that for the pre-1981 eleven-year ADR with ITC. The JCT method, which excludes ITC, would result in present value recovery of less than three-fourths of the IDC's incurred.

The right to deduct the IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. It is an important right since it helps to attract investment into oil and gas development despite the high financial risks and costs. Oil and gas wells are expensive and have rapidly become more so as the search for new supplies has extended into harsher environments and farther offshore in greater water depths. Only about one in five wildcat wells find oil in commercial quantities and many of those fail to cover their total costs. Numerous dry holes are encountered even in drilling operations in areas where oil and gas reserves are known to exist.

Further limitation of the right to deduct IDC expenditures currently would cause the withdrawal of significant amounts of capital from oil and gas exploration and development. As a result, there would be less drilling and less oil produced with the attendant loss of tax receipts because of lower windfall profit and corporate income taxes. See, "The Economic Impact of the Intangible Drilling and Development Costs (IDC) Tax Provision on the Petroleum Industry," April 1983. Prepared for the American Petroleum Institute by Price Waterhouse.

EXHIBIT B.—COMPARISON OF THE PRESENT VALUE OF VARIOUS COST RECOVERY ALLOWANCES AND THE INVESTMENT TAX CREDIT (ITC)

[Amounts in dollars]

	Present value for $1 investment					
	At 15 percent			At 10 percent		
	Cost recovery	ITC	Total	Cost recovery	ITC	Total
Equipment:						
5-yr ACRS (production and refining):						
With 10 percent ITC, basis adjustment for ½ of ITC	0.72	0.22	0.94	0.78	0.22	1.00
With 8 percent ITC, no basis adjustment	.76	.17	.93	.83	.17	1.00
11-yr ADR with 10 percent ITC under prior law (production)	.63	.22	.85	.72	.22	.94
13-yr ADR with 10 percent ITC under prior law (refining)	.59	.22	.81	.68	.22	.90
Intangible drilling and development costs (IDC):						
Current expensing—full investment is deducted in the year cost is incurred, no investment tax credit (ITC)	1.00	0	1.00	1.00	0	1.00
TEFRA, H.R. 4961 treatment of IDC 85 percent current expensing, 15 percent recovered through 36 mo. straight-line amortization with no ITC or basis adjustment: [1]						
15 percent capitalized	.97	0	.97	.98	0	.98
If 100 percent were capitalized	.82	0	.82	.87	0	.87
H.R 4961 (Senate 1982) treatment of intangible development costs (IDC) 85 percent current expensing, 15 percent recovered under 5-yr ACRS with 10 percent ITC and basis adjustment for ½ of ITC:						
15 capitalized	.96	.03	.99	.97	.03	1.00
If 100 percent were capitalized	.72	.22	.94	.78	.22	1.00
JCT staff "tax expenditure" methodology	.63	0	.63	.72	0	.72

[1] Assumes half-year averaging convention.

C. Percentage depletion—Background.—Generally, depletion is a method of recovering capital invested in the extraction of oil, gas and certain other minerals. As in other businesses, certain costs are considered capital investments and not eligible to be currently expensed.

Typically, the largest such capital cost is the cost of acquisition of the right to extract oil, gas, or other minerals. This is treated as a capital cost for both financial and tax accounting. A significant portion of capitalized costs of an oil or gas property (for tax purposes) consists of geological and geophysical costs associated with surveying and evaluating a potential oil and gas property. Although these costs may be expensed for financial purposes, they must be capitalized for tax purposes. In this sense if the "tax expenditure" concept is valid, this treatment is a "reverse expenditure" or the denial of normal recovery methods to the taxpayer. Moreover, it diverts the attention of exploration personnel from their primary function of searching for oil and gas by requiring them to ascertain which expenditures lead to the acquisition or retention of a particular property.

For tax purposes depletion is the prescribed method for recovery of capital for this investment. Two types of depletion are available under the Internal Revenue Code.

The first type of depletion is cost depletion. Cost depletion is the amortization of all capitalized costs associated with the right to the minerals and their extraction. Typically recovery is on the unit-of-production method. This is a type of straight-line recovery which requires that the initial capital is roughly recovered equally by each unit produced. The full capital cost is, therefore, not recovered until the economic exhaustion of the production. Over the past decade, this approach would have failed to keep pace with inflation and provide adequate capital recovery to enable the producer to replace reserves produced.

The second type of depletion is percentage depletion. Under that method a fixed percentage (currently 16 percent, reduced to 15 percent for 1984 and thereafter) of gross income from producing operations (but limited to 50 percent of net income of the producing property) is available to certain taxpayers as a deduction. As in the cost depletion calculation, the deduction will reduce the remaining basis or unrecovered investment in the property (but not below zero).

Since the Tax Reduction Act of 1975, percentage depletion has been available only with respect to certain oil or gas up to 1,000 barrels per day of oil (or equivalent) if produced by, or on behalf of, an "independent producer or royalty owner," i.e., not an integrated oil company. Percentage depletion has been repealed for the integrated company except for a small portion attributable to gas, the price of which has been fixed at very low rates by contract and by regulation.

D. Percentage depletion as a "tax expenditure".—Comparing tax receipts under current law against those that would have been collected had there never been percentage depletion initially appears to be a simple task, if one assumes that the "normal structure" is cost depletion. However, a cost depletion norm is not economically justified.

Unlike the situation in the manufacturing sector of our economy where technological developments have often made replacement machinery and new investment more efficient at the original or even reduced cost, the situation in the petroleum industry is one of higher costs and higher risks associated with finding new reserves. Reserve additions have increasingly been located in deeper zones or in otherwise more operationally difficult, and hence expensive, areas like deep offshore waters, the Alaskan Arctic, etc. Drilling costs have escalated as many wells have been drilled deeper and reserves discovered per well drilled have become smaller.[6] Yet for a long-lived property, cost depletion, one of the slowest methods of capital recovery in the Code, substantially decreases the present value of future cost deductions. By contrast, ACRS investors in manufacturing equipment enjoy present value recovery more nearly equivalent to current expensing since they are able to deduct their investment within a minimum of five years after operation begins, even if the expected productive life of the investment is longer.

Cost depletion not only fails to recognize the higher real replacement costs in the oil and gas industry, but it also does not account for the enormous amount of inflation experienced during the last decade, as noted earlier in relation to IDC's. The industry's real cost of capital invested in the acquisition of oil and gas properties in recent years has been substantially "underrecovered" due in large part to inflation. Only current expensing completely mitigates the effects of inflation, while ACRS with the ITC does much to neutralize it. But neither of these methods is available for "depletable costs." The oil and gas industry is thus penalized both by its high risk, high cost nature and by inflation while other much less risky industries have been allowed more generous capital recovery mechanisms and investment stimuli (i.e., the ITC).

The only method which even begins to recognize the unique nature of this industry is one based on the cost of replacing existing reserves. The income generated by the sale of production from these reserves represents the consumption of a nonrenewable capital asset. As such, it is reasonable to consider the cost of replacing the reserves as the base on which capital recovery allowances should be computed, rather than historical cost. Indeed, Congress first adopted percentage depletion in 1926 as a substitute for depletion based on value of reserves in the ground, and for nearly 50 years it served as an effective yet simple measure of replacement cost recovery. The current rate for percentage depletion (16 percent) falls substantially below the current value of reserves in the ground as a percentage of wellhead price.

The current sales prices of proven reserves of oil are reported in the press to average about $7–8 per barrel in the ground depending on a number of variables including individual well and reservoir characteristics and differing investment objectives. This cost is equivalent to roughly ¼ of the average current wellhead price of oil. Thus a rate of percentage depletion equivalent to 25 percent would be required to allow sufficient capital recovery to match the current replacement value of domestic reserves of oil and gas. In contrast to other methods of adjusting for inflation (such as indexing costs) this method is simple to administer and reaches the desired objective.

IV. Conclusion

In addressing the presently projected out-year budget deficits, Congress should first enact the promised further expenditure reductions, mindful of the potentially harmful effect taxes—especially hastily conceived taxes—can have on the economy. However, should subsequent economic conditions become clear and compel Congress to raise revenues, a tax meeting the following minimum standards would have the least adverse impact on the economy:

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[6] (See statistics contained in the "Annual Survey of Oil and Gas," published by the Bureau of the Census, and the Joint Association Survey.)

(1) Avoids penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the U.S. regardless of where produced while not increasing the cost of goods exported from the U.S.

(2) Is neutral in impact on individual competitors and industries with regard to choice of investments or consumption expenditures or form of organization.

(3) Does not sharply affect the distribution of the tax burden by being overly regressive or progressive.

(4) Avoids negative impact on incentives to save and invest.

Assistance League of Boise,
Boise, Idaho, July 25, 1983.

Hon. Daniel Rostenkowski,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Chairman Rostenkowski: The Assistance League of Boise is on record as urging your Committee to oppose any effort to put a cap on Charitable Contributions Legislation. We urge you to support H.R. 1315 to make it a permanent part of the Tax Code.

Thank you.

Sincerely,

Mrs. James A. Sullivan,
President, Assistance League of Boise.

Statement of the Associated General Contractors of America

SUMMARY

I. Employer-Provided Medical Care.—AGC is opposed to the imposition of income, social security (FICA), or unemployment taxes (FUTA) on any portion of employer-provided medical care. Current proposals for taxing benefits provided by multi employer plans are unworkable. An alternative method based on industry experience is suggested.

II. Fringe Benefit Taxation.—AGC suggests extending the present moratorium on the publication of regulations governing the tax treatment of fringe benefits.

III. Estate and Gift Taxation.—AGC is opposed to "freezing" scheduled increases in the unified estate tax credit and reductions in the maximum rate of taxation. Suggestions regarding continuing technical problems associated with the payment of estate taxes in installments are made.

IV. Foreign Technical Assistance Taxes.—AGC suggests enacting H.R. 1609 as a method of increasing federal revenue. The legislation would correct an international double taxation problem which prevents U.S. companies from competing effectively in many parts of the world unless they are able to perform certain services outside of the U.S. Changing the U.S. treatment of technical assistance taxes will result in the transfer of service functions to the U.S. and increased contract awards for firms which cannot compete under present rules.

STATEMENT

The Associated General Contractors of America (AGC) represents more than 32,000 firms including 8,500 of America's leading general contracting companies which are responsibile for the employment of more than 3,400,000 individuals. These member contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial, and municipal-utility facilities. AGC members also perform approximately 50% of the contract construction performed by American firms abroad.

We are pleased to submit written testimony on 1983 revenue increase proposals. Our specific comments cover the proposed cap on employer provided medical coverage and fringe benefit taxation, effects of the "tax freeze" proposal, and H.R. 1609 which will eliminate certain trade barriers faced by U.S. international construction contractors and raise new revenues.

I. Employer-provided medical care

AGC supports the long established national policy of excluding employer-provided medical care from taxation at the employee level while allowing employers to deduct the cost of such care as a business expense. The traditional justification for treating health benefits as a nontaxable benefit is as sound today as it has been in the past. Employer-paid medical care benefits assure that employees will seek health care as needed, encourages cost efficient preventive health care, and gives employees the security of knowing that if a health problem arises they will not be economically disadvantaged.

The national policy has always allowed employers, and in the case of unionized workers, employers and employers through process of free collective bargaining, to decide on the level of coverage which should be provided. There is no reason to change this policy now. In addition it is important to keep in mind that the cost of providing benefits varies in each part of the country and the level of benefits desired or needed by the various groups of employees also varies. A uniform national cap on the maximum excludable benefit will result in a lower level of health care in high cost areas and generally restrict the coverage of benefits such as dental and vision care and preventive treatment.

In addition to opposing the imposition of income taxes on employees for any portion of employer-provided medical care we are opposed to subjecting such benefits to either social security (FICA) or unemployment (FUTA) taxes. Social security and unemployment benefits are designed to provide important benefits to workers based on wage levels. Health care benefits have never been considered as part of the wage base. Privately provided health benefits compliment public social programs and are significantly more efficient programs for providing benefits. The imposition of either FICA or FUTA taxes on these benefit programs will only restrict the more efficient private programs in favor of less efficient public programs. In addition to these general policy considerations, unique administrative problems are associated with the taxation of health care benefits provided under multi employer plans commonly found in the construction industry.

A. Multi-employer plans

The construction industry in the United States is characterized by thousands of small highly competitive firms. An individual firm has varying labor requirements depending on the number and type of projects it is performing. Electricians, plumbers, plasterers, masons, carpenters and a variety of other skilled tradespersons often work for several firms in a single month. In addition, both employers and employees must be geogrpahically mobile due to the inherent changes in work sites necesitated by construction.

The unique nature of employment in the construction industry has led to the creation of multiemployer plans. These plans, which are maintained pursuant to collective bargaining agreements, cover millions of construction employees and receive constributions from thousands of construction employers. They have proven most effective for providing health-care coverage for construction workers given the high turnover, geographic mobility, and seasonality of the construction industry. They provide the only practical method for providing benefits to construction workers, who because of the nature of the industry, often are employed by numerous construction employers in a single year.

Generally, these plans function in a manner which leaves all day-to-day administration, record keeping, and paper work to the plan itself. Covered employees' claims for benefits are filed directly with the plan and the employer's only responsibility is to make agreed-to contributions. This centralized administrative function is a significant and key factor enhancing the effectiveness and efficiency of these plans in providing benefits to employees.

Prior imposition of FICA taxes on short-term disability benefits provided by multiemployer plans has lead to a highly inequitable distribution of the tax liabilities among employers when the plans have chosen not to pay the FICA tax and file all necessary paperwork as permitted by P.L. 97-123. Fortunately, the majority of construction industry multiemployer plans in the United States have chosen to centralize this process rather than pass on either the paper work of FICA tax liabilities to contributing employers. Unfortunately a minority of plans have chosen not to be designated as the "employer" for these purposes and have passed the paperwork and FICA tax payment onto the "last employer". This is not only an inequitable distribution of the tax liability because an employee may have only worked one day for the "last employer" but has caused employers significant administrative burdens which were intended to be mitigated by the formation of multiemployer plans. As a result, AGC urges that if the tax cap proposal is enacted, the multiemployer plans themselves be designated as the entity responsible for all administrative functions and payment of FICA and FUTA taxes associated with employer-provided health care coverage. Employers, as the sole contributors to these plans, would still bear this cost through their contributions and the plan would continue to enjoy the advantages of centralized administration. S. 640 properly delays the effective date of the proposed statute to allow time for the collective bargaining process to adjust to this new federal requirement.

While the legislative proposal includes a special provision for multiemployer plans which is a recognition of their unique nature, AGC is concerned that these special rules will still result in a inequitable distribution of the tax liability and additional administrative problems for contributing employers. The resultant paper work required of each employer will be significant and undermine one of the principal advantages of multiemployer plans in the construction industry—centralized administrative functions. AGC is also of the opinion that the endless paper trail created by such rules will prove to be unauditable by the IRS.

Our review of the multiemployer plan provision included in S. 640 indicates that the formula for allocating liability for employer-provided health care is based on a percentage of the employer's contributions to the multiemployer plan. This is inappropriate given that the contributions received by multiemployer plans are utilized to provide two types of additional coverage which significantly affect costs. Employer contributions are utilized not only to fund the health care coverage of "employees", but are often used to provide health care coverage for retirees. More important, the same contributions on behalf of working covered "employees" often are used to provide coverage for workers during periods of unemployment. As a result, any calculation of the amount contributed on an employee's behalf for purposes of the cap must be adjusted to take into account these extra benefits provided out of an employer's contributions. The current allocation formula included for multiemployer plans fails to recognize these additional costs.

II. Fringe benefit taxation

The current moratorium on the issuance of regulations by the Internal Revenue Service covering the taxation of non-statutory fringe benefits should be extended. The current proposals of the Treasury Department of either disallowing business deductions for the cost of benefits or imposing an excise tax on the employer on the value of the benefits are totally inappropriate and should be rejected by Congress. The cost of providing benefits are necessary business expenses under Section 162 of the Internal Revenue Code.

III. Estate and gift taxation

AGC's principal concern with estate taxes is to ease the burden of transferring a closely-held business following the death of a controlling principal. The construction industry is characterized by thousands of small firms which are highly competitive. These firms are often family owned and operated. The imposition of estate taxes creates serious obstacles to the continuation of many companies. If estate taxes cannot be paid a firm is faced with either liquidation or sale to another firm which is usually significantly larger. Both the amount of the tax and method of payment are crucial factors to a firm's continuation after the death of a controlling principal.

The Economic Recovery Tax Act of 1981 (ERTA) made a number of significant and beneficial changes in the estate tax laws. Some of these changes have not yet become effective. AGC supported the estate tax provisions in ERTA and continues to support them. We also support the sense of the Senate Resolution 126 and House Resolution 216 which reaffirms the Congressional support of the 1981 changes and their continued implementation. Specifically we support the scheduled increases in the unified estate tax credit up to $192,800 for decedents dying after 1987 and the scheduled reduction of the maximum estate tax rate to 50 percent in 1985. Both the increases in the unified credit and scheduled estate tax reductions are necessary to help prevent forced sales of closely-held family businesses in order to pay estate taxes. Together with the other ERTA changes, these provisions should not be tampered with.

AGC also supports the provisions of S. 1251. ERTA made a number of significant and beneficial changes in the availability and operation of Section 6166 which allows for the installment payment of estate taxes. Despite these changes, qualification and administrative rules governing the installment payment of estate taxes continues to be an uncertain and unnecessarily awkward procedure. The provisions of S. 1251 provide many technical revisions to this important aspects of estate taxes which should be acted upon by Congress. While more significant reforms of estate tax laws may be made in future years the technical corrections to Section 6166 should be made now. These changes will not affect the estate tax liabilities, only the method of payment is revised to provide certainty in business planning with some lessening of the initial impact of the estate tax liability.

It must be remembered that the availability and administration of the installment payment of estate taxes affect *all* small business—construction companies, farmers, and retail businesses. Following are several of the provisions of S. 1251 which are of particular concern to the typical estate including a construction company or other closely-held business.

The first issue concerns the clarification of corporate and partnership holding companies. In order to reflect present business practices which oftentimes utilize complex corporate and partnership holding company structures, Section 6166 should be clarified to permit a decedent to own a direct or indirect interest in a corporation or partnership carrying on a trade or business. There is no justifiable reason for the Internal Revenue Code to exclude partnership and corporate holding companies from the benefits of Section 6166. Failure of Section 6166 to deal with this normal method of business planning only frustrates the Congressional purpose underlying 6166—i.e. to provide a long-term payment procedure to estates to prevent forced sale or liquidation of the business.

Another example of a common business practice which should be supported by the Code rather than hampered is the treatment of post-death buy out agreements. Buy-out agreements are often an essential element in the continuation of a closely held business after the death of one of the owners. Section 6166 should be amended to permit an estate to sell its stock or partnership interest in exchange for a note without resulting in an acceleration of the estate tax liability.

Section 6166 should also be amended to eliminate the distinction between voting and nonvoting stock, and, the distinction between partership capital and profit interests. Under present law, if a corporation has more than 15 shareholders (determined by applying attribution rules), the decedent must own 20 percent or more of the voting stock to qualify under Section 6166. The distinction between voting and nonvoting stock for this ownership test serves no valid purpose. The death of a 20 percent shareholder can result in a business disruption regardless of the type of stock owned. Similar changes are appropriate when the business is conducted in the form of a partnership and the distinction is made on the basis of capital and profit interests.

Another overriding problem in this area is the fact that any dispute which arises under Section 6166 cannot be resolved in court, making the IRS the sole arbiter of all controversies. This imbalance between the taxpayer and the Service needs to be remedied through the creation of a judicial forum to resolve disputes. A declaratory judgment procedure in the Tax Court subject to appellate review procedures would provide a satisfactory solution.

The issues reviewed are only the highlights of S. 1251. We believe these and other issues can be resolved in a manner that will benefit all closely-held businesses in an equitable fashion and not result in a serious revenue loss to the Treasury.

IV. Foreign technical assistance taxes

AGC believes the provisions of H.R. 1609 and S. 1550 will raise federal revenues by eliminating an international double taxation situation which prevents U.S. construction contractors from competing effectively. While there are many obstacles to successfully competing in the international construction market, a relatively new and growing trend of foreign technical assistance taxes is confronting American construction firms who, when compared to their international competitors, are subject to tax rules which place them in a non-competitive position.

Technical assistance taxes are imposed on payments for construction project services which are not performed in the country where the subject is being built. The tax generally takes the form of a withholding or royalty tax which is collected and turned over to the taxing jurisdiction by the owner of the project. These taxes are commonly found in Latin American and Asian nations. A survey of the treatment of the taxes by Arthur Young and Co. (attached) shows that the U.S. tax rules are most restrictive in dealing with these taxes. U.S. restrictions produce a variety of trade barrier restraints on American firms depending on the location and scope of a firm's international operations.

A possible method of dealing with the taxes is to perform the technical services off shore. However, operating off shore can only provide relief for firms who have a sufficient volume of work to sustain such operations. Another method is to send personnel to the country in which the project is located to have them perform the services there. This is often more expensive and the employees are exempt from most U.S. taxes, if they remain overseas for over 18 months, thereby costing the U.S. tax revenues. These methods of dealing with the technical assistance taxes are awkward and often more expensive for firms which can justify them and preclude many firms from competing if they cannot. Smaller international contracting firms and firms attempting to enter the market are more severely impacted because it is more difficult to implement the laternative methods of dealing with the tax. All U.S. firms are disadvantaged because they must substitute alternative business practices for the most economic method of doing business—i.e. performing these services in the U.S.

The solution for dealing with this international double taxation problem provided in H.R. 1609 is consistent with U.S. international tax policy and the treatment accorded these taxes in countries with systems similar to the U.S. Our principal international competitors generally allow a deduction for foreign taxes imposed on domestic source income. A credit is provided for taxes paid on foreign source income. H.R. 1609 provides this treatment for American firms and will eliminate the present bias in the U.S. system by providing a tax neutral treatment of these taxes. U.S. firms now performing these services abroad will be able to relocate their operations in the U.S. Firms kept from competing off shore will be more effective in competing and generate new U.S. tax revenues from contact awards.

In analyzing the effects of H.R. 1609 it most be remembered that the U.S. engineering-construction industries have the potential to be a cataslyst for increased export trade. As the designers, planners and constructors for multi-billion dollar projects, we can provide foreign markets for U.S. manufactured materials, installed machinery and a continuing market for spare parts. Our contribution to the U.S. position in world trade, therefore, goes beyond the primary impact of initial contracts for construction and related services.

The top 400 firms in the industry in recent years have secured 30 percent of their total work from overseas projects. These international awards alone translated into revenues of $53.6 billion in 1981. While construction in the United States has declined an average by 3.4 percent per year since 1973 in real terms, construction in foreign markets has expanded. This growth largely reflects the impact of OPEC surpluses from two oil price hikes which increased overseas construction opportunities. For example, according to U.N. statistics, construction spending in the Asia-Middle East regions increased at real annual rate of 12 percent following the 1973/74 price hike.

Despite the growth of U.S. activity in construction activities during the last ten years, our share of international awards has taken a dramatic decline—from over 50 percent in the mid seventies, to less than 30 percent in 1981. Our revenues from international awards, in fact, dropped 16 percent in 1982.

American firms in our industry who venture abroad and succeed in penetrating foreign markets do so because of advanced technology and perserverance, while an endless array of government support, both visible and invisible, is provided by foreign governments to their countries' firms. What we need is the removal of barriers and disincentives to counter this. Enacting H.R. 1609 into law would remove one significant barrier and we encourage you to do so.

[From Arthur Young & Co., June 27, 1983]

SURVEY OF TREATMENT BY EIGHT COUNTRIES OF TECHNICAL ASSISTANCE TAXES

U.S. engineering and construction firms are in many instances, now effectively prevented from competing against non-U.S. firms for foreign jobs because of international double taxation of "technical assistance" services performed in the U.S.—e.g. engineering, procurement, construction management, etc. This is a serious trade barrier for U.S. firms. The major trading partners of the United States, on the other hand, generally provide relief from double taxation which facilitates competition by their home country corporations.

An increasing number of foreign countries tax gross payments for technical services performed outside of their country where the services relate to a construction project located within their country. Often these taxes are levied as a withholding tax on "royalties," broadly defined to include any type of technical services performed outside the country. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country. Under current United States tax law, these taxes withheld are "foreign income taxes" on United States source service income. Since the U.S. foreign tax credit is basically limited to U.S. tax on foreign source income, this conflict between the U.S. and the foreign income sourcing rules can result in double taxation of U.S. technical assistance.

The enclosed information is the result of our survey of the United States major trading partners' treatment of foreign taxes withheld on payments for engineering and design services and other technical assistance, performed within their borders by home country corporations for projects located outside their borders.

In reviewing how our major trading partners relieve double taxation of technical assistance, our inquiries focused on the following three mechanisms.

Foreign tax credits.—Normally this system prevents double taxation of foreign source income of home country corporations. However, if the foreign income tax is levied on domestic source income, does the particular country adjust its foreign tax credit mechanism to avoid double taxation?

Deduction of foreign taxes.—If a country taxes on a territorial basis, foreign tax credits are generally limited to those items specifically designated by a tax treaty. Often, these countries prevent double taxation of domestic source income by permitting a deduction for foreign taxes imposed on this income. Does the particular country in question permit the deduction of foreign taxes on domestic source income?

Special provisions or statutes.—Does the local taxing jurisdiction have any other special provisions which would avoid the double taxation of domestic source technical service income?

We have summarized the information on the enclosed chart and narratives. Briefly stated, it appears that, although many of our trading partners relieve double taxation through a foreign tax credit system similar to the one in the U.S., they avoid the double taxation of technical assistance described above by permitting either a deduction for foreign taxes paid on domestic source income (even if the taxpayer has elected to credit other foreign taxes against his income tax) or treating technical services as foreign source income, with a credit for the foreign taxes paid. In addition, certain of our trading partners provide incentives for companies performing this type of work. This places U.S. corporations at a competitive disadvantage with our major trading partners' home country corporations.

TECHNICAL ASSISTANCE TAX SURVEY

	United States	Canada	France	Germany	Japan	Korea	Netherlands	Switzerland	United Kingdom
Foreign tax credit:									
Credit allowed against home country taxes for foreign taxes withheld attributable to services performed in home country.	No[1]		Yes[2]			Yes		Yes[2]	Yes.[2]
Deductibility of foreign taxes:									
Deduction allowed against home country income for foreign taxes withheld attributable to services performed in home country.	No	Yes	Yes	Yes	Yes		Yes	Yes	Yes.
Any other special provisions or statutes	No[3]				Yes	Yes			

[1] Due to mechanics of U.S. foreign tax credit limitations.
[2] Credit against home country taxes may be allowed by treaty.
[3] Except limited DISC application.

Note.—See attached summaries for captioned detailed analysis.

CANADA

Foreign tax credit: Canada generally allows foreign tax credits only with respect to non-Canadian source income.

Deductibility of foreign taxes: Canada allows a deduction for foreign taxes paid on Canadian source income.

Special provisions or statutes: None.

Summary: Canada permits the deduction for taxes withheld on Canadian source technical assistance income.

FRANCE

Foreign tax credit: France generally does not have a foreign tax credit mechanism since it only taxes income earned within France. However, certain tax treaties provide that taxes paid to treaty countries on French source income will be allowed as foreign tax credits.

Deductibility of foreign taxes: France allows a deduction from gross revenues for foreign taxes paid on French source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes: None.

Summary: France may by treaty permit a foreign tax credit for taxes withheld on French source technical assistance income. Otherwise, France treats the withheld tax as a reduction of taxable revenues, i.e., the equivalent of a deduction.

GERMANY

Foreign tax credit: Germany generally allows foreign tax credits only with respect to non-German source income.

Deductibility of foreign taxes: Germany allows a deduction for foreign taxes paid on German source income.

Special provisions or statutes: None.

Summary: Germany permits a deduction for taxes withheld on German source technical assistance income.

JAPAN

Foreign tax credit: Japan generally allows foreign tax credits only with respect to non-Japanese source income.

Deductibility of foreign taxes: Japan generally does not allow a deduction for foreign taxes paid if the taxpayer has elected to credit other foreign taxes. However, if the tax is attributable to income derived from overseas technical services (see discussion of special provisions or statutes), the foreign tax is deductible in full.

Special provisions or statutes: Income derived from overseas transactions of technical services generate a special deduction equal to 16 percent of the net income. Overseas transactions of technical services includes planning, consultation, supervision, and other items related to the construction or production of plant or equipment.

Summary: Japan permits a deduction for foreign taxes paid on Japanese source income if the income is derived from planning, consultation, supervision and other items related to the construction or production of plant or equipment.

KOREA

Foreign tax credit: Korea treats proceeds received from overseas for engineering, design and other technical services performed in Korea by a construction company in connection with a construction project located in another country as foreign source income and any taxes withheld are entitled to foreign tax credit treatment.

Deductibility of foreign taxes: Korea does not allow a deduction for foreign taxes.

Special provisions or statutes: 50 percent of the income from technical assistance performed in Korea for foreign owners are exempt from taxation for six years. This exemption does not apply to a construction company and design and engineering services performed for the construction of a building. Foreign tax credit is not allowed on income subject to this exemption.

Summary: Korea permits a foreign tax credit for taxes withheld on Korean source technical assistance income.

NETHERLANDS

Foreign tax credit: The Netherlands generally allow foreign tax credits only with respect to non-Netherlands source income.

Deductibility of foreign taxes: The Netherlands allow a deduction for foreign taxes paid on Netherlands source income.

Special provisions or statutes: None.

Summary: The Netherlands permit a deduction for taxes withheld on Netherlands source technical assistance income.

SWITZERLAND

Foreign tax credit: Switzerland generally allows no foreign tax credits with respect to non-Swiss source income. However, certain tax treaties provide that taxes paid to treaty countries on Swiss source income will be allowed as foreign tax credits.

Deductibility of foreign taxes: Switzerland allows a deduction for foreign taxes paid on Swiss source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes: None.

Summary: Switzerland may by treaty permit a foreign tax credit for taxes withheld on Swiss source technical assistance income. Otherwise, Switzerland allows a deduction for taxes withheld on Swiss source technical assistance income.

UNITED KINGDOM

Foreign tax credit: The United Kingdom generally allows foreign tax credits only with respect to non-United Kingdom source income. However, certain tax treaties provide that taxes paid to those treaty countries on United Kingdom source income will be allowed as foreign tax credits.

Deductibility of foreign taxes: The United Kingdom allows a deduction for foreign taxes paid on United Kingdom source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes: None.

Summary: The United Kingdom may by treaty permit a foreign tax credit for taxes withheld on United Kingdom source technical assistance income. Otherwise, the United Kingdom allows a deduction for taxes withheld on United Kingdom source technical assistance income.

STATEMENT OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

We are submitting these comments in response to proposals which have been discussed publicly to freeze the limits under Internal Revenue Code (IRC) Section 415 on the amounts which may be set aside to provide retirement benefits from tax qualified pension plans. These limits are currently scheduled to be indexed for cost-of-living increases commencing in 1986.

We are providing these comments because we feel that it is essential that the Committee be aware that the freezing of the Section 415 limits would significantly reduce the pension which could be funded and paid from a qualified pension plan to an employee who makes as little as $13,000 in 1983.

As you recall, these limits were recently rolled back by the Tax equity and Fiscal Responsibility Act of 1982 ("TEFRA") from $136,425 to $90,000 for defined benefit plans and from $45,475 to $30,000 for defined contribution plans. TEFRA also reduced the aggregate benefits in cases where a single employer has a defined contribution and defined benefit plan, from 140 percent of the combined benefit to, essentially, 125 percent.

As originally proposed (under the "Pension Equity Tax Act of 1982," HR-6410), these limits would not have been indexed to cost-of-living increases. However, after hearings which touched upon this issue, Congress recognized that freezing these limits would adversely impact the funding of retirement income of middle and lower paid employees. As a result, while TEFRA ultimately rolled back the dollar and combined limits as described above, it permitted these benefit limitations to be indexed to cost-of-living adjustments similar to those used to adjust Social Security benefits.

Recent proposals to freeze the benefits limits require that this issue be reexamined. Unlike the indexing of Social Security benefits, the index on the Section 415 limits does not automatically increase a benefit currently being paid to middle and lower paid employees when the cost-of-living adjustment is applied. Instead the index on these benefits under Section 415 permits an employer to set aside sufficient amounts to provide reasonable income upon the retirement of such middle and lower paid employees in the future.

In order to illustrate this point we have drawn several examples from the Sun Company, Inc. employee population. Sun, as you know, is an integrated oil company with worldwide operations. Sun possesses a defined benefit plan, the Sun Company, Inc. Retirement Plan, as its primary source of retirement benefits. This plan provides basic retirement income to approximately 18,000 employees. Sun supplements these retirement benefits through a defined contribution program which is called SunCAP. This program combines a cash or deferred (401(k)) plan with a thrift plan feature and provides for up to 15 percent pretax employee contributions, the first 5 percent of which are matched on a dollar for dollar basis by employer contributions. The average salary paid to all Sun employees covered by these plans (including exempt, nonexempt and hourly workers) is approximately $35,000; the median income is $30,000.

For the sake of discussion let us assume a typical Sun employee who earns $30,000 in 1983. Let us assume further that this employee will retire at age 65 with total service at retirement of 30 years. During the employee's career, Sun's actuaries assume that his or her real wages will grow at 2 percent per year, over and above inflation of 7 percent per year.

If we assume, for the moment, that Sun has only a defined benefit plan, when the employee described above retires in the year 2013, the benefit he or she would be entitled to under the Sun Retirement Plan, assuming the present law permitting the indexing of benefits to cost-of-living stays the same is, in 1983 dollars, $16,409. However, if the limits are frozen, the maximum benefit payable from the Sun Retirement Plan would be $11,823. If we step back into the reality of Sun's benefit program and take into account the contributions to SunCAP on behalf of this employee under the combined limitations, assuming the individual dollar amounts are not indexed, the maximum retirement benefit that could be paid from the Sun Retirement Plan would be reduced from $16,409 to $6,340 measured in 1983 dollars.

Even though the above example speaks of benefits that will be provided in the year 2013, the present limits, if frozen, would prevent Sun from putting aside the necessary dollars today to fund the income currently promised under the Sun Retirement Plan which we hope to pay this employee and others when he or she retires. As a result, the difference between the amount which may be put aside in a tax qualified plan, subject to the ERISA guarantee of advanced funding and insured by the PBGC, and the benefit that Sun Retirement Plan promises to its average worker must be funded out of the general assets of the corporation at the time of retirement and would not be subject to the guarantees provided by ERISA or the PBGC.[1]

This growth of "nonguaranteed benefits" is illustrated by the red areas of Exhibits I and II. As is indicated in Exhibit I,[2] if we assume the existence of a defined benefit plan only and that the $90,000 maximum benefit is frozen until the year 2013 when the employee retires, the great majority of the benefit to be provided to that employee and to other employees who today earn $23,000 per year or more would be unfunded and payable from nonguaranteed sources.

If we assume that Sun's benefit structure remains as is, with the inclusion of both a defined contribution and a defined benefit plan, the maximum benefit which could be paid from the Sun Retirement Plan would be $48,000.[3] As illustrated under Exhibit II, the freezing of the Section 415 limits in Sun's case will reduce the projected retirement benefits and the current funding on behalf of all covered Sun employees who today earn about $13,000 per year or more.

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[1] Of course, some employers, especially those in declining industries, may not be willing or able to continue pensions at the present level. In this case the freezing of the benefit limitations would result in a legally permitted, gross reduction of future retirement income for middle and lower paid employees; a result of which no one wishes to encourage.

[2] Employees above the line on Exhibits I and II are impacted; employees below the line are not. We have also illustrated on both Exhibits the impact of both a salary growth of 6 percent per year (i.e., 4 percent inflation plus 2 percent real growth) and 9 percent (7 percent inflation plus 2 percent real growth). Nine percent represents the current salary assumption under the Sun Retirement Plan.

[3] Annual additions to Sun's defined contribution plan, SunCAP are assumed to be 20 percent of earnings (5 percent employer and 15 percent employee pre-tax). Therefore, the defined contribution fraction would be 80 percent (20 percent/25 percent) which is .571 of the defined contribution limit on a percentage basis under Section 415 as amended by TEFRA. The difference between the maximum combined limitation (1.00) and .571, or .429 would be adjusted under Section 415 by a multiplier of 1.25 which yields .536. This amount (.536) when multiplied by the $90,000 limit yields a maximum defined benefit amount of approximately $48,000.

Freezing these limits for even a short time, upon the expectation that Congress will later increase them in the future, similarly distorts the funding of the pensions of these middle and lower paid employees. When Congress later acts to unfreeze the limits, plans such as the Sun Retirement Plan and Sun's SunCAP, will be forced to make up for lost contributions over a shorter period of time. Naturally some employers will be willing and able to do so, while some will not. In either instance, the certainty that adequate retirement benefits would be provided would be jeopardized.

The freezing of these limits would likewise reduce supplemental retirement income derived through savings put away for retirement under defined contribution plans. In Sun's case, the company began encouraging employee savings in 1926 under a stock purchase program which later evolved into SunCAP. Today, nearly 80 percent of its employees participate in the Company sponsored defined contribution plan. If the limits for contributions are frozen, the amounts which can be saved for retirement under this and similar plans will dwindle significantly in terms of today's dollars.

The implication of these statistics is clear. In your concern over cost-of-living adjustments in general, please do not confuse the indexing of benefits currently being paid with the provision for adequate pensions to be paid in the future. We recognize that the issue is complicated, but the simple answer of freezing the limits brings us back to the years before ERISA when nonguaranteed benefits were standard, continued pensions uncertain, and poverty in retirement, common.

EXHIBIT I

SUN COMPANY, INC.
RETIREMENT PLAN
IMPACT OF $90,000 MAXIMUM BENEFIT
AGE 65 WITH 30 YEARS OF SERVICE

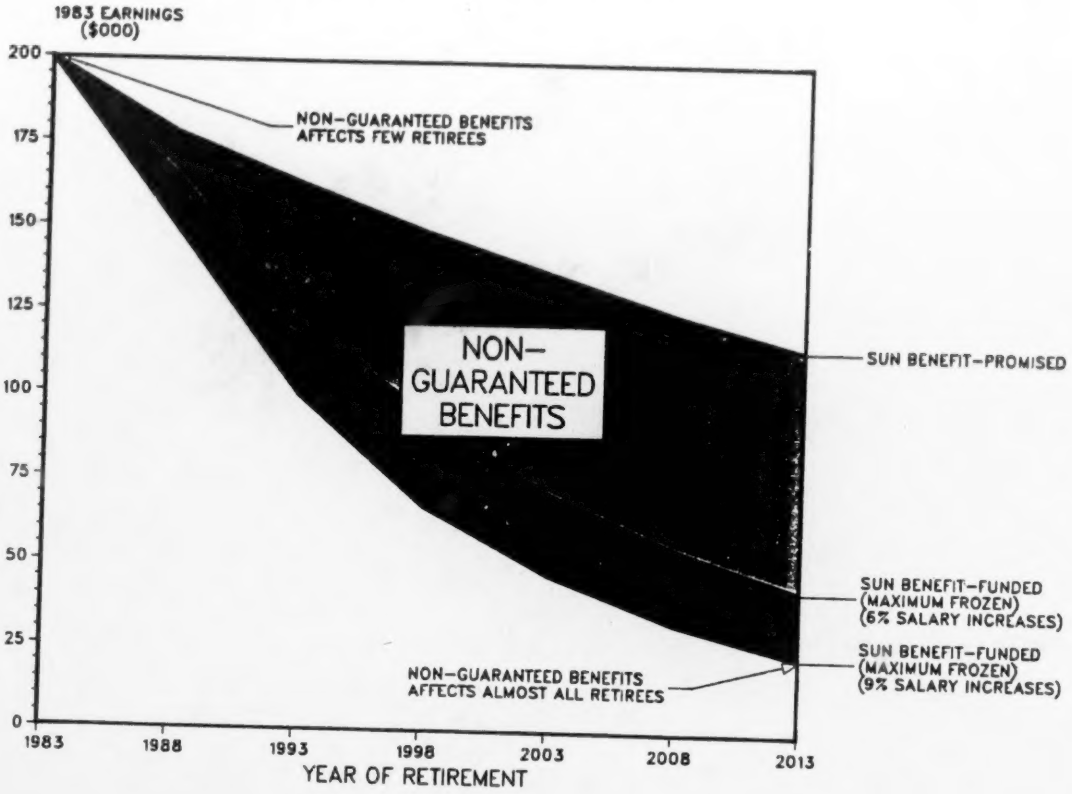
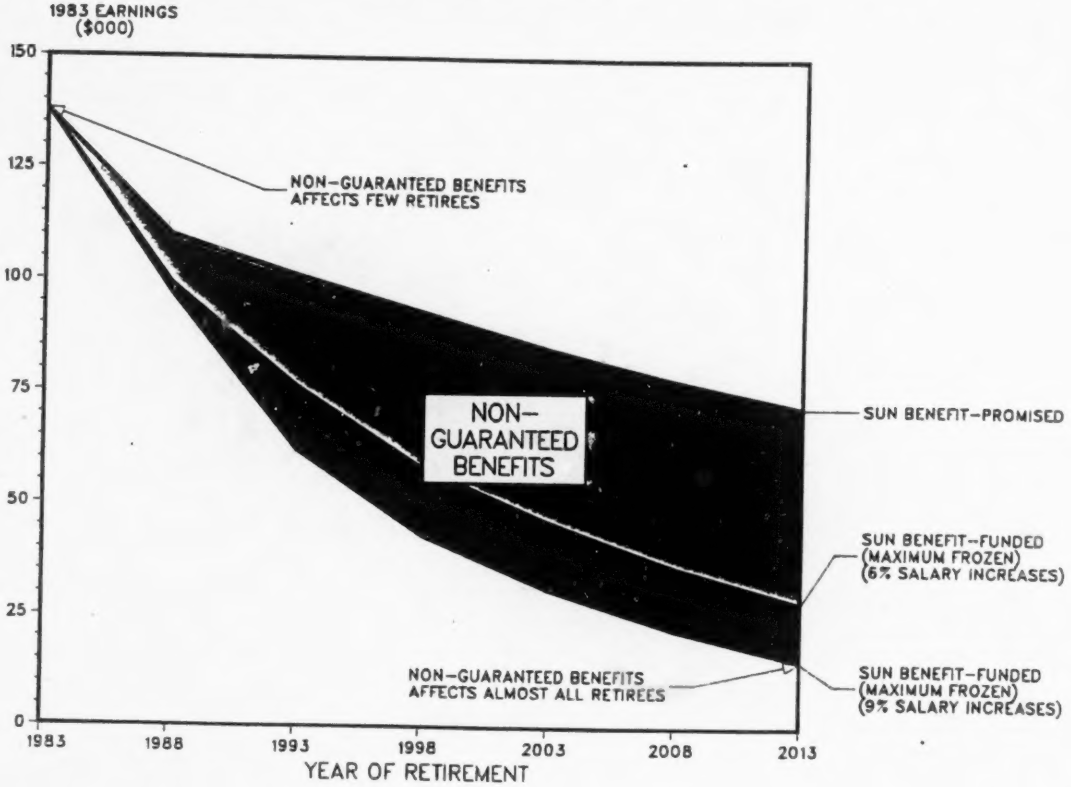


EXHIBIT II

SUN COMPANY, INC.
RETIREMENT PLAN
IMPACT OF $48,000 MAXIMUM BENEFIT
AGE 65 WITH 30 YEARS OF SERVICE



STATEMENT OF THE BLUE CROSS AND BLUE SHIELD ASSOCIATION

The Blue Cross and Blue Shield Association is the national coordinating organization for all the Blue Cross and Blue Shield Plans. We appreciate this opportunity to present our views on the Administration's proposal to cap the tax exemption for employer-paid health insurance premiums. Today, Blue Cross and Blue Shield Plans serve more than 80 million Americans under our private business and 20 million Americans under our activities as intermediary or carrier for the Medicare, Medicaid and CHAMPUS programs.

We share your concern about the massive Federal deficit and the need to contain health care costs so that the overall upward pressure on Federal health care expenditures can be slowed. While we believe that changes are needed in some of the incentives present in our health care system, we do not believe that the Administration's current proposal is a well-conceived reform of that system.

Those who favor the tax cap argue that such a cap would result in greater cost consciousness on the part of consumers about the amount and type of health insurance purchased, and, thus, would ultimately contribute to a reduction in health care expenditures and prices. Proponents also argue that, to the extent that it would not cause greater cost consciousness, a tax cap would generate revenues for the Federal government. Finally, regardless of whether or not the tax cap would help contain costs or generate revenues, some proponents argue that it would reform the tax system and correct an inequity enabling persons in higher income brackets to benefit more from the tax exclusion than those in lower income brackets.

We consider the tax cap to be poor public policy—as a cost containment strategy, as a device for generating Federal revenues, and as a reform of the tax system. We believe a tax cap will:

(1) Impact workers by having an inequitable and adverse effect on low-income, older and disabled workers, as well as workers who have family members suffering from chronic illness;

(2) Impact employers by introducing a host of new complications and costs;

(3) Impact cost containment initiatives by inhibiting the continued development and application of more effective cost containment methods; and

(4) Probably fail in its objective of raising additional government revenue.

I would now like to discuss these four effects in more detail.

IMPACT OF THE TAX CAP ON WORKERS

Tax cap proponents have argued that the current exclusion disproportionately benefits higher income workers. But, in fact, all non-taxable fringe benefits favor higher income employees. Using this argument to promote the taxation of health insurance obscures significant facts about how the private insurance mechanism works to assure that adequate protection is there for those who need it the most—the sick.

While higher paid workers do receive a relatively greater tax advantage from the current exclusion, a wide range of workers have benefited substantially because comprehensive coverage became accessible to workers who otherwise could not have afforded it. Thus, the exclusion has permitted private insurance to support broader public policy objectives in an appropriate partnership with the government.

Tax experts may debate these questions, but it is at the time of need that the real impact of a tax cap will be felt, and those who would carry the heaviest burden are those who can least afford it.

Adverse effects on older, chronically ill and disabled workers.—In response to a tax cap, employers might reduce their premium contributions by either reducing coverage or by adding more cost-sharing to the insurance package. Either action would have a regressive effect on older, chronically ill or disabled persons. Because their higher illness rates result in more frequent use of health services—and thus higher out-of-pocket costs—they would be paying more for access to health care.

Such a cap also might represent an increased financial burden for those employers who have aged or disabled employees. The higher health care costs of these employees result in higher insurance costs for all employees in a group. And, to the extent that employment of these individuals raises an employer's health benefit costs above the cap, the amount in excess would be subject to employer-related payroll taxes (e.g., FICA), raising the cost of doing business and possibly eroding corporate profitability.

While we do not have precise estimates of the financial impact of a tax cap on groups with these "high risk" workers, Blue Cross and Blue Shield Association actuarial simualtions suggest how the Administration's proposal might affect older workers. The additional taxable income for family Blue Cross and Blue Shield coverage in Florida (with a 75 percent employer contribution) is estimated to be 31 times higher for workers employed in older employee groups (average age 55–64) than in younger groups (average age 35–44)—$1,306 versus $41.

Adverse effects on low-income workers.—The progressive nature of our income tax structure results in any tax exclusion being worth more from a tax perspective to persons in higher income brackets than in lower brackets The proposed tax cap, however, can be viewed as regressive taxation. According to studies by Gail Wilensky and her former colleagues at the National Center for Health Services Research, while a smaller propertion of people with low incomes would be affected by a tax cap, for those affected, it would represent a larger portion of their income as compared to higher income workers. For example, workers who earn less than $10,000 a year would pay an additional $85 in taxes, or an additional 1.4 percent of their income, as a result of the Administration's proposed tax cap. Workers earning more than $50,000 a year would pay $227 in taxes which represents 0.3 percent of their income.

These studies also have shown that employer contributions for health benefits are high for a substantial number of low-income workers. These workers are low wage earners in high benefit industries, for example, entry-level Federal government workers or low wage earners in manufacturing industries. A tax cap could mean a loss of compensation for these workers, unless offset by increases in wages or in other fringe benefits.

Moreover, any employer reaction to a tax cap such as reducing insurance coverage, adding cost-sharing, or raising catastrophic expense limits also would be regressive for low-income workers. Such changes in the benefit package could severely compromise the ability of low income workers and their families to seek needed primary care since they would find it difficult to pay directly for services.

Adverse selection.—One of the underlying assumptions of tax cap proponents is that the tax cap will promote greater consumer choice in the marketplace. If given a choice, they argue, individual consumers will make knowledgeable and economically rational decisions that will set in motion a variety of changes, which eventually will result in lower health care costs.

However, from our experience as insurers, we do not believe that multiple choice results in constructive cost containment. If employers respond to the tax cap by offering employees a choice between lower-cost and higher-cost plans, those who perceive themselves as healthier likely would choose a lower-cost, minimal coverage plan, whereas less healthy workers likely would choose a more comprehensive benefit, high-cost plan. The result of such segmentation of risks and its financial consequences we refer to as "adverse selection." Over time the cost of providing services to the high users drives up the premiums and the healtheir workers drop out.

Unfortunately, once an adverse selection dynamic is established, in any group, it becomes progressively worse. A spiral develops in which the experience, and thus the costs, of the segmented groups grow further apart. The financial feasibility of maintaining coverage for the poorer risk groups disintegrates. The principle of group insurance—of spreading the risks widely—is lost. This adverse selection spiral would put the affordability of the more comprehensive, higher-cost option out of reach for the low-income, aged, or disabled worker who needs the protection.

Geographic inequities of a tax cap.—Another inequity arises from the use of a national tax cap. Unless the level of the cap is regionally adjusted, which is administratively difficult, the tax burden will fall most heavily on higher cost areas of the nation. Coincidentally, these are often the very areas which already tend to be suffering the highest levels of unemployment and where employers can least afford any new payroll costs. Moreover, in any region of the country, employers who offer good continuation coverage for laid-off workers would be discouraged from doing so, for the cost of such continuation coverage usually is built into the rates for the regular group coverage.

IMPACT OF A TAX CAP ON EMPLOYERS

A tax cap could have at least three adverse effects on employers by increasing the overall cost of doing business through increased payroll taxes and administrative burdens; preventing uniformity in benefits for geographically dispersed employers; and complicating labor relations.

A major impediment to implementing a tax cap is the absence, in many cases, of a premium against which to judge an employee's tax liability. The proposed tax cap legislation assumes that employers pay a fixed, monthly premium or contribution for single and family health coverage. This is not a universal practice. Insurers and employers now use a wide variety of mechanisms to price and finance health benefits.

Much of the group health insurance provided today is not based on "premiums" attributable to individuals or families in an employer's group. These non-premium arrangements include: various kinds of self-insurance under which companies pay claims as they are incurred; 501(c) trust funds; "administrative services only" arrangements, under which a carrier performs administrative services but claims are paid by the employer as they are incurred; and others. Often an employer's health benefits will be divided among a number of insurers—different carriers may have coverage for physician care, hospitalization, major medical and dential insurance. The employer may even self-insure for an initial deductible—the first $1,000 or $2,000—in combination with use of multiple carriers.

Even where premiums are established for large groups, they often intentionally are not calculated to reflect real or anticipated costs until well after the close of the contract year. This is necessary to enable insurers to compete with self-insured programs which focus on the employer retaining and earning interest on his cash.

Thus, these commonly used financing arrangements do not lend themselves to determining a premium amount which is reliable or equitable enough for employers to use in computing employee taxable income.

Even if an equitable premium could be established without radically changing the way employee benefits are financed, employers would face other administrative problems. Many companies have operations in several areas, with more than one insurance carrier or with different benefits plans for different classes of employees. Complex record systems would have to be established to accommodate all these differences in calculating taxable income for employees.

In addition, a tax cap on health insurance premiums could increase employers' overall cost of doing business. To the extent that any employer's contribution to employee health insurance premiums were to exceed the cap, the excess contribution would be subject to additional payroll taxes (e.g., FICA and unemployment). Alternatively, employers might respond to the preferences of certain employee groups by providing lower health insurance premium contributions (below the cap) and additional wages. These additional wages would be subject to payroll taxes.

If these increases in company administrative and payroll costs could not be passed on to the consumer in the form of higher prices or be borne by employees in the form of lower compensation, corporate earnings would diminsh.

A tax cap might also pose significant equity issues for employers who have operations in different states or even in different areas in the same state. Since health insurance premiums for the same benefit package can vary dramatically across the nation and between urban and rural areas, a tax cap might result in additional taxes for employees in one area but not in others. Employers would find it extremely difficult to assure equal benefits throughout their companies.

Finally, under the Administration's bill, employers might find themselves faced with the prospect of having to reopen collective bargaining negotiations on contracts entered into after January 31, 1983. For example, a recent contract between the steelworkers union and management specifically included a provision that if a new tax cap bill is passed, the union and the companies will "meet to consider revisions which would minimize worker tax liability."

USE OF TAX CAP AS A COST CONTAINMENT DEVICE

Proponents of a tax cap argue that it would reduce the rate of increase in health care expenditures by promoting greater cost-sharing. While we would agree that a tax cap may accelerate the trend to greater cost-sharing, and thus may reduce expenditures for health insurance premiums, we do not believe that it would result in substantial savings in total health care expenditures. Rather, we believe that a limitation on health insurance premiums would not contain total health care costs because it could result in elimination of the most cost-effective benefits and discourage certain cost containment activities.

Elimination of cost-effective benefits.—We are concerned that abruptly imposing a limit on employer-based health insurance may result in elimination of or reduced coverage for those benefits which have a lower cost per unit of service such as preventive care, outpatient physician services and home health care. Employees, historically, have been most concerned about retaining maximum coverage for hospital inpatient care and other more financially threatening medical expenses. Just as insurance was initially chosen to cover the highest cost services—such as hospitalization—and only later was extended to cover lower cost services such as physician office visits, hospital outpatient visits and prenatal care, abrupt curtailment of benefits may result in a reversal of that pattern of coverage.

Yet it is expanded coverage for selected outpatient, lower-cost services which appears to be effective in containing costs over the long-term. A recent Johns Hopkins University Study indicates that the increase of outpatient care coverage by Blue Cross and Blue Shield Plans across the country resulted in the substitution of these services for expensive inpatient care, and contributed to a steady decline in Blue Cross inpatient admissions during the period 1970–1979. Throughout this period, Blue Cross admission rates declined by about two-thirds of one percent annually, whereas comparable admission rates for the general population under age 65 were rising at a rate of 1.3 percent each year.

We believe that while some savings in premium expenditures might be realized in the near-term, the effect of a tax cap on efforts to control total health care expenditures could be counter-productive. The greater part of the health cost problem—institutional costs—may remain largely untouched.

Discouragement of cost containment activities.—We believe that tax caps may deter, in some cases, insurers and employers from developing new cost containment strategies. In recent years, insurers have pursued a variety of innovative cost control programs which are, or have promise of, holding down health care costs. For example, our Plans have developed a variety of programs such as utilization review, medical necessity review, and promotion of new benefit design packages to shift hospital care to appropriate lower-cost settings. Blue Cross and Blue Shield Plans have invested heavily in the development of alternative delivery systems to help control health costs. Indeed, our Plans are the most prolific developers of health maintenance organizations. Also, a number of Blue Cross and Blue Shield Plans are offering or developing preferred provider arrangements.

Development of these innovative cost control programs is expensive, particularly during the start-up period. If a tax cap is imposed, employers and insurers would have less incentive to incur the costs of such programs in the hope of future savings. A real question for an employer or insurance company would then be whether the benefits to be gained from cost containment activities can be clearly shown to be greater than those to be achieved by simply raising employee cost-sharing.

Finally, it would be simplistic to assume that insurance is the only driving force in rising costs. Rising personal incomes, rising expectations about health, increasing advances in science and medicine, development of more intensive medical care services and products, general inflation in the economy, and the aging of our population all have contributed to rising costs. Public and private policies of past decades to expand the supply of health resources and to promote health insurance coverage in order to provide greater access to health services also contributed to increased utilization.

Moreover, insurers have a tradition of competing to offer the public and employer groups the products most desired. Until recently, cost containment was not a high priority, but now, it is the predominant focus in our industry, and is having an impact.

In our own case, we know that the growing sophistication of our medical necessity evaluations, the wider application of new benefit and utilization control programs, and the development of tighter contractual arrangements with providers are enabling Blue Cross and Blue Shield Plans to exercise more control over some of the less tractable sources of increasing expenditures. Our experience in provider contracting and in applying cost containment programs to diverse settings will help us develop even better capabilities. The forces of competition are leading other carriers and providers to strive for improved results.

EFFECT OF TAX CAPS ON FEDERAL REVENUES

We believe that the estimates of revenues to be derived from a tax cap are overstated. Recent experience with flexible benefit plans leads us to believe that employees, if given the option, may shift that part of their compensation above the tax cap to non-taxable fringe benefits. It also should be noted that a tax cap may actually promote the development of new non-taxable benefit programs.

The revenues produced from a tax cap would be far less than projected and, more importantly, would be largely derived from those who are among the more vulnerable in our society—the older, sick or disabled workers and their families who, because of their perceived medical needs, choose more comprehensive health care coverage.

SUMMARY

In conclusion, we strongly recommend that Congress not impose a tax cap on employee health benefits. Such a tax would result in little or no overall health cost savings and would do little to raise revenues. It would, however, have several detrimental effects: a tax cap may result in the elimination of potentially cost-effective benefits and it would have a disproportionate adverse effect on aged, ill, disabled and lower-income workers.

Also, while the Administration states that it wants to limit tax increases, the proposed tax cap is clearly a new tax on working Americans.

STATEMENT OF COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

Introduction

The Committee for Effective Capital Recovery is a voluntary coalition of 577 business firms and 54 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation, and utilities. A list of the member companies and supporting associations is attached (see Appendix A).

Formerly called the Ad Hoc Committee for an Effective Investment Tax Credit, the Committee has long been active in efforts to improve, strengthen, and make permanent capital cost recovery allowances, devoting itself initially to the investment tax credit.

The Committee for Effective Capital Recovery vigorously believes that the capital recovery provisions provided by the Economic Recovery Tax Act of 1981 (ERTA) should not be further diluted and that the curtailments made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) should be restored.

In any event, we do not believe that a tax increase is necessary at this time. Should the Congress ultimately determine that a tax increase is necessary to reduce our deficits and that serious considertion should be given to structural changes in our tax laws (e.g., a consumption-based tax), we would urge that the need to provide incentives to savings and investment be adequately reflected in such changes.

I. ECONOMIC RECOVERY TAX ACT OF 1981

By 1981 the urgent need for improved capital recovery was acknowledged by virtually every member of Congress, by most economists, and by the general public. This focus on improved capital recovery was not surprising. At that time it had become clear that two of the most pressing economic problems facing this nation were its declining productivity and its loss of competitiveness with other nations. Both problems were in large part the result of the United States' tax system. Corportions were paying huge federal taxes on illusory profits—profits that resulted solely from the impact of inflation. Such taxes led to reduced corporate cash flows and inadequate capital investments—which have had a slow but seriously deleterious impact on the economic health of our nation and its ability to compete with other nations.

One of the important keys to economic recovery was believed to lie in increased savings and investment in plant and equipment. In 1979 business savings comprised approximately 76 percent of the total national savings, and capital recovery allowances accounted for approximately 88 percent of all business savings. Thus, if savings was to be increased, capital recovery allowances had to be improved.

In its 1981 deliberations, Congress considered a variety of competing proposals, all of which provided for some form of accelerated capital recovery. While Congress adopted the Accelerated Cost Recovery System (ACRS) or 10-5-3 proposal, it was only after considering the explicitly rejecting immediate expensing of capital investment in personal property as an alternative.

Under ACRS as originally enacted, the cost of eligible personal property is recovered over a 3-year, 5-year, or 10-year period depending upon the type of property involved. Cars, light-duty trucks, R&D equipment, and other short-lived property are in the 3-year class. Most other personal property is in the 5-year class as are single-purpose agricultural structures and petroleum storage facilities. Ten-year property includes certain public utility property and real property with a class life of 12½ years or less. Other real property is placed in a separate 15-year real property class. Under ACRS, salvage value is not taken into account.

For personal property placed in service in 1981 through 1984, ERTA had provided a recovery method approximately equal to the benefit obtained by using a 150 percent declining-balance method for the early years, with a switch to the straight-line method for the remainder of the recovery period. This method had been scheduled to change (1) in 1985 to approximate the 175 percent declining-balance method, with a switch to the sum-of-the-years-digits method; and (2) in 1986 and thereafter, to approximate the 200 percent declining balance method, with a switch to the sum of-the-years-digits method.

Under ERTA, three-year recovery property was eligible for a six percent investment tax credit and five- and ten-year recovery property was eligible for a full ten percent investment tax credit.

Had these provisions been untampered with, we may well be further along the road to recovery than we are now. Unfortunately, in 1982—barely one year after ERTA was enacted—the benefits provided by the ACRS provisions were significantly curtailed.

II. TAX EQUITY AND FISCAL RESPONSIBLITY ACT OF 1982

While ERTA was estimated to provide business tax cuts in excess of $150 billion over six years, TEFRA was designed to increase business taxes by in excess of $100 billion over six years. In large part, TEFRA's tax increase was achieved by limiting the capital recovery provisions, which limitation accounted for almost one-half of the $100 billion tax increase.

Essentially, TEFRA amended the capital recovery provisions by requiring a taxpayer to reduce the basis of his assets by 50 percent of the amount of investment tax credits, energy credits, and certified historic structure credits earned with respect to the property. Alternatively, taxpayer was given the option with respect to the regular investment tax credit on recovery property to elect a 2-percentage point reduction in the credit instead of the basis adjustment.

Additionally, TEFRA limited the use of the investment tax credit to only 85 percent of the regular tax liability, rather than 90 percent; and repealed the increased rates of recovery scheduled to go into effect in 1985 and 1986.

By enacting TEFRA a mere one-year after ERTA, it appears that the United States has again adopted the tragic on-again-off-again investment tax credit policy that prevailed through the 1970's. In so doing, it is unfortunate that the Congress ignored the ample evidence indicating the need to permit sufficient time to elapse before the full effect of such incentives can be measured.

III. WHERE WE ARE TODAY

While our nation is now in the midst of an economic recovery, we must not jeopardize that recovery by adverse changes in our tax policy. The recovery has begun with interest rates already at very high levels—rates which are starting to move up again. Money supply is growing faster than the guidelines the Federal Reserve has set for itself. And huge budget deficits continue to be projected into the future. Thus, despite the recovery, the danger of an increase in inflation has risen, which could bring with it a reversal of the recovery that we have thus far seen.

Nevertheless, and notwithstanding the TEFRA amendments, some in Congress would propose limiting the ACRS provisions further yet by requiring a basis adjustment of the full amount of investment tax credit claimed, rather than a basis adjustment of one-half of the investment tax credit claimed.

These critics base their proposal on the views of some in the economic community who argue that ACRS continues to provide too great a windfall to the business community. Essentially, those arguments run along two lines: first, that ACRS provides benefits greater than expensing; and second, that ACRS results in a misallocation of investment among assets. Each of these theories, however, is beside the point, and should not warrant any change of policy from that originally intended.

A. ACRS provides greater benefits than expensing

The argument that ACRS provides greater benefits than would be available under expensing is not news, but was offered well before ACRS was first enacted. While Congress rejected it in 1981 in enacting ERTA, the same argument surfaced again in the 1982 tax debates and apparently accounted for TEFRA's curtailment of the ERTA's capital recovery provisions. In this regard, the Staff of the Joint Committee on Taxation's General Explanation of TEFRA stated:

"Cost recovery deductions for most personal property allowed under ACRS, in combination with the regular investment tax credit, generated tax benefits which had a present value that was more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made; i.e., more generous than the tax benefits of expensing."

Even after the TEFRA amendments, however, some in the economic community maintain that ACRS continues to provide greater benefits than expensing. Essentially, these critics have noted that few corporations are subject to tax at a 46 percent marginal tax rate, but most are subject to federal tax at a lower rate. Therefore, these critics argue that the present value of the ACRS deductions and the investment tax credit should be compared with the present value of expensing using a marginal tax rate less than 46 percent. And their calculations show that, at marginal tax rates below 46 percent (with particular interest assumptions), ACRS with the investment tax credit is indeed more favorable than expensing.

In responding to this argument, it is important to recognize that these critics are ignoring the effect of other taxes on capital. At the federal level, dividends are taxed upon distribution to individual shareholders and the capital gains tax is paid upon the sale of their stock. In addition, state and local governments impose income and property taxes on corporations. The effect of these various levels of taxation is to increase the effective tax on an asset acquired by a corporation beyond the marginal federal income tax rate.

Moreover, while it is true that corporations are generally subject to a marginal federal tax rate below 46 percent, the effective marginal tax rate is not as low as some critics would have one believe. The U.S. Department of Treasury's "Statistics of Income, 1980 Corporate Income Tax Returns" indicates a total corporate income subject to tax that year of $247 billion on which a U.S. tax of $63 billion was paid, for an effective U.S. tax rate on U.S. corporations' worldwide income of almost 26 percent. But the amount of U.S. taxes paid reflects a reduction of almost $25 billion (i.e., over 10 percent) due to foreign taxes paid. When U.S. taxes are increased by creditable foreign taxes, the 1980 effective tax rate on U.S. corporations was approximately 36 percent.

Assuming a marginal tax rate of 36 percent, whcih as indicated above understates the total tax burden on corporate investment, the following comparison of expensing versus ACRS (with the one-half ITC basis adjustment) may be made:

Present value of ITC and future tax savings at selected discount rates—36 percent assumed tax rate (per $100 cost)

Expensing	$36.00
3-year (6 percent ITC):	
12 percent	36.88
16 percent	35.77
5-year (10 percent ITC):	
12 percent	37.23
16 percent	35.52

At a 12 percent discount rate, ACRS provides a slight benefit over expensing. And at a 16 percent discount rate, ACRS is clearly less advantageous than expensing. Thus, ACRS will provide greater benefits than expensing only at relatively modest interest rate assumptions. But the notion that our tax policy should be based on low and stable interest rates is not practical. Experience has shown that interest rates fluctuate. Businesses must be able to plan ahead with certainty and cannot be asked to face the risk of shifting tax policy based upon shifting interest or discount rates.

In any event, the assumption that benefits greater than those available under expensing is in some way inappropriate is itself subject to question. Other provisions of our tax Code may result in benefits greater than those available from current expensing (e.g., the R & D credit and the jobs credit), as may provisions in the tax laws of our trading partners. If a goal of our tax policy is to stimulate increased business investment—and we believe that it should—benefits greater than expensing are entirely appropriate.

B. Misallocation of capital

The second argument that has been advanced against ACRS is that the capital recovery provisions, together with the investment tax credit, result in an inefficient allocation of investments among assets and among industries. Proponents of this position argue that the ACRS and investment tax credit rules tend to favor investment in short-term assets over long-term assets. This argument is premised upon the assuption that it is best for society if the rate of return on different assets is not affected by the tax system.

Obviously, there is unlikely to be any capital recovery system that would be perfect in this respect. However, one economist, Jane Gravelle of the Congressional Research Service, has attempted to quantify what she terms "inefficiencies" in investment allocation. These inefficiencies accrue from the potential of the tax law to modify the flow of capital between more or less productive assets.

She compared the inefficiencies existing under ERTA and TEFRA with those existing prior to ERTA. Her analysis considered the effect of tax policy on the allocation of capital both within the corporate sector and between the corporate and noncorporate sectors, thereby considering its total effect on economy-wide investment uses.

Her results are summarized in Table I.

TABLE I.—ANNUAL INEFFICIENCY IN INVESTMENT ALLOCATION [1]

[In billions of dollars]

Sector	Pre-ERTA	ERTA [2]	Effect of ERTA [3]	TEFRA	Effect of TEFRA [3]	Combined effect of ERTA and TEFRA [3]
Intracorporate only	3.3	3.8	+0.5	1.5	−2.3	−1.8
Economywide (total)	17.4	11.9	−5.5	11.6	−.3	−5.8

[1] All estimates measure impact of relevant law if it had been implemented in 1980.

[2] Based on depreciation schedule to have become effective in 1986.

[3] Positive numbers reflect additional inefficiency, while negative numbers reflect inefficiency.

Source: Figures obtained from statement of Jane Gravelle made at the Annual Symposium of the National Tax Association to be published in the forthcoming September 1983 issue of the National Tax Journal. The study assumes Cobb-Douglas production functions, unitary price elasticities of demand for each type of labor, capital and final output, and exponential depreciation. Consumer durables, housing, and inventories are included as investments in non-corporate sector; education, gold, collectibles and other investments are excluded. See source for assumptions on investment financing, personal tax rates, and other items. State and local taxes are not considered.

Gravelle found that tax law prior to ERTA caused in 1980 an inefficiency or distortion in the allocation of corporate investment equal to $3.3 billion. This amount represents the difference between the allocation of the corporate sector's investment under such tax law and the "optimum" allocation of such investment.

She estimated that under ERTA, the corporate inefficiency would have been $3.8 billion per year, or an increase of $.5 billion over the pre-ERTA level.

When, however, Gravelle considered the efficiency of total or economy-wide allocation of investment, she found that by ERTA's lowering of effective corporate tax burdens relative to non-corporate taxes, efficiency was increased by a net gain of $5.5 billion per year.

Accordingly, this work contradicts claims of some critics that ERTA interfered with efficient flow of investment between alternative uses.

In the case of TEFRA, while the tax changes increased "efficiency" of corporate investment ($2.3 billion), the overall effect was not statistically significant ($.3 billion).

Thus, contrary to popular impression, ERTA improved the allocation of investment in the economy while TEFRA had little or no effect on such allocation.

In addition, these tax changes have had a large and favorable impact on the level of investment, a far more significant factor than their effect on allocation of capital. Allen Sinai, Andrew Lin, and Russell Robins at Data Resources, Inc. have analyzed the combined impact of ERTA and TEFRA. They estimate that they will increase 1985 investment in plant and equipment by $17 billion relative to the amount which would have occurred had pre-ERTA legislation remained in effect.

Certainly there seems little justification at present on allocation grounds to further curtail the capital recovery provisions of ERTA.

IV. WHERE DO WE GO FROM HERE?

ERTA was proposed and enacted as a multi-year tax act. Both the Administration and the Congress promoted the need for a multi-year act to provide a stable tax environment for business. Without such a stable tax environment, American business is unable to make intelligent investment decisions. With the enactment of ERTA, many companies commenced planning major capital investments to be placed in service in future years. These investments were initiated, in large part, as a result of the commitment made by the Administration and Congress that the tax package enacted in 1981 would continue in place. The modifications made in TEFRA undoubtedly made some of these investments financially impossible, as they adversely altered the projected rate of return available from such investments. The further erosion of ERTA's capital cost recovery provisions would frustrate our national goal of stimulating corporate savings and investment, and thus the Committees would vigorously oppose any such proposals.

Moreover, the Committee for Effective Capital Recovery joins those groups in opposing any tax increase this year or next. While the outyear deficits remain a serious problem, we believe that dealing with them via a tax increase would, at this time, jeopardize the continuation of the recovery we are now experiencing.

Further, if the Congress considers major structural changes in our tax laws, we would urge that attention be given to a method of taxation which rewards savings and investment. Our tax laws are unique among industrial countries, as most derive a major portion of their revenues from consumption taxes or other methods of avoiding our present bias against savings and investment. And these countries generally have higher levels of personal savings, capital formation, and productivity growth than does the United States. Thus, at an early time, careful consideration of a consumption tax for the United States may be necessary.

Appendix A.—Committee for Effective Capital Recovery

MEMBERSHIP, JULY 22, 1983 (577 MEMBERS)

ALUMAX, Inc., AMAX, Inc., AMCA International Corporation, AMP Incorporated, ASARCO, Incorporated, A-T-O, Inc., Acme-Cleveland Corporation, Aileen, Inc., Air Products and Chemicals Inc., Airco, Inc., Akzona Incorporated, Albany International Corp., Allegheny International, Inc., Allegretti & Company, Allen-Bradley Co., Allied Products Corporation, Allis-Chalmers Corporation, Aluminum Casting & Engineering Co., Aluminum Smelting & Refining Co., Amerace Corporation, American Brands, Inc., American Can Company, American Financial Corporation, American Greetings Corporation, American Hoechst Corporation, Hoist & Derrick Co., American International Group, Inc., American Maize Products Co., American Natural Resources System, American Petrofina, Inc., American Thread Company, Ampex Corporation, Amtel, Inc., Anchor Hocking Corporation, Apache Corporation, Arcata National Corporation, Arkansas Best Corporation, Arrow Gear Co., Arvin Industries, Inc., Ashland Oil, Inc., Atlantic Metals Corporation, Atlantic Richfield Company, Automatic Catering, Inc., Avnet, Inc., Avon Products, Inc.

Bache Halsey Stuart Shields Inc., Ball Corporation, Baltimore Gas and Electric Co., BankAmerica Corporation, Barry Wright Corp., Bartlett-Brainard & Eacott, Inc., Bartlett and Company, Grain, Baxter Travenol Laboratories Inc., Bear Creek Corporation, Beard Oil Company, Beatrice Foods Co., Beech Aircraft Corporation, Belden Corporation, Bell & Howell Co., Bemis Company, Inc., Beneficial Corporation, The Berkline Corporation, Betz Laboratories, Inc., Big V Supermarkets, Inc., Binney & Smith, Inc. Black & Decker Mfg., Co., Blandin Paper Co., Bliss & Laughlin Industries, Bloom Engineering Company, Inc., Blue Bell, Inc., Blue Bird Body Company, Blue Ridge Stone Corp., The Boeing Company Bowater North Armerica Corp., Brown Transport Corp., Brunswick Corporation, Bucyrus-Erie Company, The Budd Company, Bunker Ramo Corporation, Burlington Industries, Inc., Burroughs Corporation, Bush Brothers & Company, Butler Manufacturing Company.

CBI Industries, Inc., CBS Inc., CCI Corporation, C/E Construction Company, CF Industries, Inc., CSX Corporation, California Casualty Insurance Group, Cameron Iron Works, Inc., Carlisle Corporation, Carnation Company, Carolina Freight Carriers Corp., Carpenter Technology Corporation, Carrier Corporation, Casa Grande Valley Newspapers Inc., Castle & Cooke, Inc., The Ceco Corporation, Central and South West Services, Inc., Cessna Aircraft Company, Champion International Corp., Chart House Inc., Chemetron Corporation, The Chesapeake Corporation of Virginia, Chesebrough-Pond's Inc., Chicago Pneumatic Tool Company, Chloride Incoporated, Christie Electric Corp., Chromalloy American Corporation, Chincinnati Incorporated, The Cincinnati Mine Machinery Co., Citicorp, Cities Service Company, The Citizens and Southern National Bank, City Investing Company, Clark Equipment Company, Clearprint Paper Company, Inc., Clow Corporation, Coachmen Industries, Inc., Coastal Corporation, Coats & Clark Inc., The Coca-Cola Bottling Co. of New York, Inc., Coca-Cola Bottling Co. of South Arkansas, Collins & Aikman Corporation, Colt Industries Inc., Columbia Gas System Service Corp., Columbus McKinnon Corporation, Cominco American Incorporated, Commercial shearing, Inc., Comtel Corporation, ConAgra, Inc., Concise Casting Corporation, Congoleum Corporation, Connecticut General Insurance Corp., Conoco Inc., Consolidated Foods Corporation, Consolidated Freightways, Inc., Consolidated Papers, Inc., Consumers Power Company, Consumers Steel Co., Inc., Container Corp. of America, The Continental Group, Inc., Continental Illinois Corporation, Continental Machines, Inc., Continental Telephone Corporation, Cooper Industries, Inc., Cooper Tire & Rubber Company, The Cornelius Company, Crankshaft Machine Company, Crocker National Bank, Crompton & Knowles Corp., Crouse-Hinds Company, Crutcher Resources Corp., Cubic Corporation, Cyclops Corporation, Cyrpus Mines Corporation, Dana Corporation, Dart Industries, Inc., Dataproducts Corporation, Daylin, Inc., Dearborn Rubber Corporation, Deere & Company, De Kalb Agresearch, Inc., DeLaval Turbine, Inc., Delsteel, Inc., Delta Brick & Tile Company, Inc., Delta Steamship Lines, Inc., Deluxe Check Printers, Inc., Dennison Manufacturing Company, Detroitbank Corporation, Diamond Shamrock Corporation, Dibrell Brothers, Inc., A. B. Dick Company, Di Giorgio Corporation, Digital Equipment Corp., Dixie Yarns, Inc., DoAll Company, Dominion Mortgage & Realty Trust, Donaldson Company, Inc., R. R. Donnelley & Sons Company, Dover Corporation, Dresser Industries, Inc., Dundee Cement Company, and Dynamics Corp. of America.

E-Systems, Inc., Eagle-Picher Industries, Inc., Earth Resources Company, Eastern Gas and Fuel Associates, Jas. D. Easton, Inc., Eaton Corporation, The Echlin Manufacturing Company, Economics Laboratory, Inc., Edwards Brothers Incorporated, EL–GE Potato Chip Co., Inc., Electronic Memories & Magnetics Corp., Elgin National Industries, Inc., Elk Yarn Mills, Inc., Davis H. Elliot Company, Inc., Eltra Corporation, Emerson Electric Co., ENTELCO Corporation, Erb Lumber Company, Erie Castings Company, Esmark, Inc., Esterline Corporation, Eubanks Engineering Company, Evans Products Company, Everett/Charles, Inc., Ex-Cell-O Corporation.

FMC Corporation, FMR Corporation, Fairfield Manufacturing Co., Inc., Farmland Industries, Inc., Federal-Mogul, Federal Paper Board Company, Inc., Federated Department Stores, Inc., Ferguson Enterprises, Inc., Finch, Pruyn & Co., Inc., First American Bank, N.A., Washington, First Bank System Inc., The First National Bank of Chicago, Fischbach Corporation, The Flintkote Company, The Fluor Foundation, Ford Motor Company, Foremost-McKesson, Inc., The Foxboro Company, Franklin Electric Co., Inc., Frional Industries, Inc., Fruehauf Corporation, Fuqua Industries, Inc., Furnas Electric Company.

GK Technologies Incorporated, Gamble-Skogmo, Inc., Gannett Co., Inc., Gast Manufacturing Corporation, General Care Corporation, General Cinema Corporation, General Dynamics Corporation, General Foods Corporation, General Portland Inc., General Signal Corporation, General Telephone & Electronics Corp., Getty Oil Company, Giddlings & Lewis, Inc., Gifford-Hill & Company, Inc., Gilbane Building Company, Gould Inc., W. R. Grace & Co., Grafton Foundry Company, Great Northern Nekoosa Corporation, Green Bay Packaging Inc., Greif Brothers Corporation, Greyhound Leasing and Financial Corp., S. J. Groves & Sons Company, Grow Group, Inc., The Guardian Life Ins. Co. of America, Gulf Oil Corporation.

H & H Industries, Inc., Hannaford Bros., Co., Hardee's Food Systems, Inc., Harnischfeger Corporation, Harris Corporation, Harris Trust & Savings Bank, Harsco Corporation, Hart Schaffner & Marx, Hayes-Albion Corporation, Walter E. Heller International Corp., Hershey Foods Corporation, Hesston Corporation, Hewlett-Packard Company, The Higbee Company, Hillyer Corporation, Edward Hines Lumber Company, Homestake Mining Co., Houdaille Industries, Inc., Household Finance Corp., Harvey Hubbell, Inc., S. E. Huffman Corp., Hughes Tool Company, Hurco Manufacturing Co., Inc., Hyster Company.

IC Industries, Inc., IU International Corp., Iandoli's Super Markets, Inc., Ideal Basic Industries, Inc., Illinois Tool Works, Inc., Inco Electroenergy Corp., Ingersoll-Rand Company, Inland Steel Company, Intel Corporation, International Business Machines Corp., International Minerals & Chemical Corp., International Multifoods Corp., International Paper Company, International Proteins Corp., International Telephone & Telegram Corp., Internorth, Inc., Iowa Beef Processors, Inc., Island Creek Coal Company.

JLG Industries, Inc., Jewel Companies, Inc., Johns-Manville Corp., Johnson Controls, Inc., Johnson & Johnson, Earle M. Jorgensen Co., Josten's, Joy Manufacturing Company.

Kaiser Cement Corporation, Kaman Corporation, Keebler Company, Kendavis Industries International, Inc., Kennametal Inc., Kennecott Corporation, Kerr-McGee Corporation, Kingsbury Machine Tool Corporation, Kirsch Company, Kraft, Inc., Kuhlman Corporation, Kysor Industrial Corporation.

The LTV Corporation, Laclede Steel Company, Lakeview Forge Company, F. Jos. Lamb Company, Lampert Lumber Company, Lance, Inc., Land O'Lakes, Inc., Lanier Business Products, Inc., Lear Siegler, Inc., Leaseway Transportation Corp., K. O. Lee Company, Lehigh Portland Cement Co., Edw. C. Levy Co., Liggett Group Inc., Lockheed Corporation, Longyear Company, The Louisiana Land & Exploration Co., Louisiana-Pacific Corporation, Lucky Stores, Inc., Ludlow Corp., Lukens Steel Company, Lykes Bros. Inc.

McCall Oil & Chemical Corp., McGraw-Edison Company, McJunkin Corporation, McKee Baking Company, McQuay-Perfex Inc., MBPXL Corporation, MCA Inc., Macmillan, Inc., Marathon Manufacturing Company, Marathon Oil Company, The Marmon Group, Inc., Marquette Company, Marriott Corp., Maryland Cup Corporation, Masonite Corporation, Massachusetts Mutual Life Insurance Co., A. T. Massey Coal Company, Inc., The Mead Corporation, Medical Mutual of Cleveland, Inc., Melville Corporation, Memorex Corporation, Menard, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Mesa Petroleum Company, Michigan General Corporation, Michigan National Corp., Microdot, Inc., Midland-Ross Corporation, Milchem Incorporated, Milliken & Company, Millipore Corporation, Mitchell Energy & Development Corp., Modern Industrial Engineering Co., Modine Manufacturing Company, Mohasco Corporation, Monsanto Company, Moore McCormack Resources, Inc., Morton-Norwich Products, Inc., Motorola, Inc., Mountain Fuel Supply Company.

NCR Corporation, NL Industries, Inc., NVF Company, Nabisco, Inc., Nalco Chemical Company, National Automatic Tool Company, National Distillers & Chemical Corp., National Gypsum Company, National Presto Industries, Inc., National Semiconductor Corp., National Starch & Chemical Corporation, Newmont Mining Corporation, Norris Industries, Inc., Northwest Industries, Inc., Northwestern Steel & Wire Co.

Oak Industries Inc., Ogden American Corporation, Olin Corporation, Otis Elevator Company, Owatonna Tool Company, Owens-Illinois, Inc., Oxford Industries, Inc.

Pantasote Company, Parker-Hannifin Corp., The Parker Pen Company, Pay Less Super Markets, Inc., Peabody International Corporation, Pechiney Ugine Kuhlmann Corporation, Pennsylvania Power & Light Company, Pepsico, Inc., Perkin-Elmer Corporation, Peter Paul, Inc., Phelps Dodge Corporation, Philip Morris Incorporated, Phillips Petroleum Company, Pitney-Bowes, Inc., Pittsburgh-Des Moines Steel Company, Pittsburgh Forgings Company, Pittsburgh & Lake Erie Railroad, Pittway Corporation, The Polymer Corporation, Portec, Inc., Porter Paint Co., Potlatch Corp., Price Waterhouse & Co., Processed Plastic Company, Public Servce Electric & Gas Co., Publix Super Markets, Inc., Purex Corporation.

RSR Corporation, Ramada Inns, Inc., Ransburg Corporation, Raybestos-Manhattan, Inc., Red Wing Shoe Company, Inc., Reeves Brothers, Inc., Reliance Electric Company, Republic Corporation, R. J. Reynolds Industries, Inc., Riegel Textile Corp., Ring Power Corporation, H. H. Robertson Co., A. H. Robins Company, Inc., Rockwell International Corp., The Roegelein Company, Rogers Corporation Rohm and Haas Company, Rohr Industries, Inc., Roper Corporation, Roto-Finish Co., The Rouse Company, Royal Industries, Rubbermaid, Inc., Russell Corporation.

SPS Technologies, Inc., Safeguard Industries, Inc., Safeway Stores, Inc., St. Joe Minerals Corporation, St. Regis Paper Company, Santa Fe Industries, Inc., A. Schulman Inc., Scientific-Atlanta, Inc., Scott, Foresman & Company, Scott Paper Company, Scovill Inc., Seal-Land Service, Inc., Sealed Power Corp., G. D. Searle & Co., Sears, Roebuck and Co., Seattle-First National Bank, The Shelby Mutual Ins. Co. of Shelby, Ohio, The Signal Companies, Inc., Signode Corp., SmithKline Corporation, Snap-on Tools Corporation, Soundesign Corp., Southern Railway System, Southwest Forest Industries, Inc., Southwestern Portland Cement Company, Sprague Electric Co., Stanadyne, Inc., Standard Brands Incorporated, Standard Oil Co. of California, Standard Oil Co. (Indiana), Standard Oil Co. (Ohio), Standard Register Co., Standex International Corporation, Stanley Home Products, Inc., Stanley Works, Stauffer Chemical Company Steiger Tractor Inc., Sterling Drug Inc., J. P. Stevens & Co., Inc., Storage Technology Corp., Sun Company, Inc., Sunbeam Corporation, Sundstrand Corporation.

TRW, Inc., Tandy Corp., Technicon Instruments Corporation, Tecumseh Products Company, A. Teichert & Son, Inc., Telautograph Corporation, Texaco, Inc., Texas Commerce Bancshares, Inc., Texas Eastern Corporation, Texas Industries, Inc., Texasgulf Inc., Thiokol Corporation, Thomas & Betts Corporation, Tiger International, Inc., Time Incorporated, The Times Mirror Company, The Timken Company, Todd Shipyards Corporation, Transamerica Corporation, Transamerica Interway Inc., Transcontinental Gas Pipe Line Corp., The Travelers Insurance Companies, Tropicana Products, Inc., Tyler Corporation, Ty-Miles, Inc.

U A L Inc., UOP Inc., Uarco, Incorporated, Unarco Industries, Inc., Union Camp Corporation, Union Carbide Corporation, Union Oil Co. of California, Union Pacific Corporation, United States Borax & Chemical Corp., United States Filter Corporation, The United States Shoe Corporation, U.S. Tobacco Co., United Telecommunications, Inc., Universal Leaf Tobacco Co.

V. F. Corp., VSI Corporation, The Valeron Corporation, Van Dorn Company, Van Pelt Corporation, Varo Inc., Vollrath Co., Vulcan Materials Company.

Walker Magnetics Group, Inc., Wallace Murray Corporation, Ward Foods, Inc., Warner-Lambert Company, Warner & Swasey Company, Wawa, Inc., Wean United, Inc., Western Electric Co., Inc., Western Publishing Company, Westinghouse Electric Corporation, Weyerhaeuser Co., Wheelabrator-Frye Inc., Wheels, Inc., Whirlpool Corporation, White Castle System, Inc., Williamhouse-Regency Inc., The Williiams

Companies, Wilsey Bennett Co., Winn-Dixie Stores, Inc., Woodward Governor Company, Woolrich Woolen Mills, Inc., F. W. Woolworth Co., Wm. Wrigley Jr. Co., Wylain, Inc., Wyman-Gordon Co.

Xerox Corporation.

Young & Rubicam Inc.

APPENDIX B.—COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

SUPPORTING ASSOCIATIONS

Air-Conditioning & Refrigeration Institute, American Boiler Manufacturers Association, American Chamber of Commerce Executives, American Consulting Engineers Council, American Dental Association, American Feed Manufacturers Association, American Iron & Steel Institute, American Land Development Association, American Machine Tool Distributors Association, American Meat Institute, American Pipe Fittings Association, American Textile Machinery Association, Apartment Owners & Managers Association of America, Associated General Contractors of America, Association of American Railroads.

Cast Metals Federation, Concrete Plant Manufacturers Bureau, Dairy & Food Industries Supply Association, Edison Electric Institute, Expanded Shale Clay & Slate Institute, The Ferroalloys Association, Foodservice & Lodging Institute, Foreign Credit Interchange Bureau, The Gummed Industries Association, Inc., Imported Hardwood Products Association, Inc., International Quorum of Motion Picture Producers, Mechanical Contractors Association of America, Meat Machinery Manufacturers Institute.

National Air Transportation Association, National Association of Home Manufacturers, National Association of Business & Educational Radio, Inc., National Association of Coin Laundry Equipment Operators, National Association of Manufacturers, National Concrete Masonry Association, National Food Processors Association, National Industrial Distributors Association, National Ocean Industries Association, National Paper Box Association, National Ready-Mix Concrete Association, National Tank Truck Carriers, Inc., National Wool Growers Association, Northeastern Lumber Manufacturers Association.

Packaging Machinery Manufacturers Institute, Penn Michael Management, Portland Cement Association, Printing Industries of America, Inc.

Railway Progress Institute, Rubber Manufacturers Association.

Screen Printing Association International, Shipbuilders Council of America, Truck Mixer Manufacturers Bureau, United Fresh Fruit & Vegetable Association.

Woodworking Machinery Distributors Association, Woodworking Machinery Manufacturers of America.

STATEMENT OF EDWIN S. COHEN, WASHINGTON, D.C.

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling in Washington, D.C. and a professor of law at the University of Virginia Law School.

I submit this statement to the Committee today solely on my own behalf and not in representation of any client or organization. I do so in order to offer to the Committee the suggestion that the federal government create a commission to consider and recommend, at an early date, measures to deal with the problems that the nation faces regarding compliance with the federal tax laws.

I have come to this conclusion with considerable reluctance. Although calls have frequently been made for commissions to study federal tax policy, I have been skeptical as to the likelihood of success because of the wide divergence of economic, social and political views on the subject.

But I suggest that the time has arrived when a governmental commission to examine and make recommendations regarding procedures for enforcement of the tax laws could make a vital contribution. I would distinguish between a commission to recommend policies as to the amount and types of taxes to be levied and one to recommend appropriate procedural means of insuring their collection. Even if the commission's procedural recommendations produced dissents or were not found acceptable to the Congress and to the President, it would nevertheless perform a distinct public service in laying out the facts and analyzing the issues and alternative remedies that are available. An objective study and comprehensive report on major compliance issues would enable the Congress to make informed decisions, and would create the public confidence and support for those decisions that are vital to the collection of the nation's revenues.

I think it may be said that the legislative and grass roots maneuvering in the past year with respect to a number of compliance issues, particularly with respect to withholding, have not been such as to inspire public confidence. Charges and countercharges have been hurled, often with little factual basis and even less logical analysis, resulting in public dismay and confusion. I do not mean to suggest that fault or blame should be assigned to anyone, but only that the present procedures for developing solutions to these major problems are falling short of the goal. I urge on you that the time has come for a fresh start on these compliance issues, and that the best available procedure is to establish a nonpartisan governmental commission charged to analyze the facts and issues and to report back, at least preliminarily, by April 1 of next year.

Designing of an efficient compliance system requires the welding of many talents. The vast recent technological advances in computers and other devices present opportunities for solutions that have only recently become available or are just on the horizon. To develop the solutions we need not only legislators, lawyers, economists, revenue estimators and government administrators, but systems analysts, private sector administrators and other experts familiar with the new and developing technology.

In my experience, both in and out of government, I have found it extremely difficult to bridge the gap between the youthful designers and operators of sophisticated modern equipment and systems on the one hand, and on the other hand the older persons who are in the position to make important policy decisions. The younger persons have grown up in a different technological environment and they speak a lingo that is difficult for their elders to comprehend. The designers and operators of the systems are not accustomed to writing memoranda or testifying in terms that policymakers understand. The objective of a commission would be, among other things, to bring these groups together and bridge the gap between them.

No one could have a higher regard than I have for the ability, intelligence and dedication of the staffs of this Committee, the Joint Committee on Taxation and the Senate Committee on Finance. They have contributed many useful ideas toward solution of the complex compliance problems we face. But their work should be supplemented by that of experts in systems and technology who can lend their experience and special training to achieving the solutions. A commission would permit this merger of expertise.

Needless to say, the International Revenue Service also has many able and dedicated experts in these fields. Unforunately, it is not likely that the Service would be regarded by the tax paying public and by payors as sufficiently neutral in weighing the alternative courses. It should, of course, be closely involved in the study and play a vital role.

I realize that the Senate amendment to H.R. 2973, adopted by the Seante several weeks ago, provides for a report on this subject to be rendered by January 1, 1988 by the Comptroller General. But that report is to deal with the collection of taxes on interest, dividends and patronage dividends, and it is not expected to be filed for another four and a half years. I suggest that there is need for a study and recommendations with respect to other types of income as well, as to which the revenue gap is understood to be greater. Moreover, some recommenations, at least, could be forthcoming well within a year's time, and the presence on the suggested commission of private citizens would be of great assistance in generating public confidence in the system.

The American Bar Association is also initiating a long-range project to study and make recommendations for improvements in tax compliance. I believe such a study is eminently desirable and should be encouraged. But I understand that the proposed American Bar Association study will be broader in scope and take longer to complete than the more limited inquiry that would be the task of the commission. The commission, I suggest, should be concerned primarily with analyzing the available systems technology—what might be called the "nuts and bolts" of compliance procedures—and the cost-benefit aspects of the possible alternative solutions.

The ingenuity of our best minds and the application of our best technology are needed to close the compliance gap. The stakes are high. Even a partial closing could produce on the order of $25 billion annually, and that saving would be a major contribution to meeting the budget deficit. This should be a national effort, in which there should be joined payors, payees and the Service, both large and small business, both academicians and practitioners, both those design and run the systems and those who make executive and policy decisions, both the bright young stars of the electronic generation and the wise and experienced gray heads. I submit to you that such an environment is not likely to exist on Capitol Hill, and that the public senses this is the case.

Thus I come to the conclusion, somewhat reluctantly but inevitably, that a governmental commission on this subject is much needed. The issues, the analyses and the proposed solutions should be laid out for the American people and their elected representatives in Congress to see and to understand. I have faith that they will respond when they are convinced that the stakes are high and that an impartial and thorough evaluation of the possible solutions has been completed.

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) is concerned about certain misconceptions relative to the general tax and accounting treatment applicable to the electric utility industry. EEI is the national association of investor-owned electric utility companies which serve 99 percent of all customers of the investor-owned segment of the industry and 76 percent of all users of electricity in the United States.

The specific charge often levelled at the industry is that utilities enhance profits and dividends by billing customers for taxes that are not paid. This is not only false, but reflects a general lack of understanding of generally accepted accounting principles and regulatory ratemaking procedures.

What is true is that electric utilities apply provisions of the tax law which are available to all other businesses—provisions designed to encourage plant expansion and modernization. These provisions, most notably accelerated depreciation and the investment tax credit, are essential if our economy is to be strong, if people are going to have jobs and if American commerce and industry are to compete in the world markets.

As intended by Congress, the application by business of accelerated depreciation and the investment tax credit has resulted in accelerated capital recovery by American business through reductions in current income tax obligations. As a result, the financial position of business generally, and the electric power industry in particular, is strengthened.

As a result of these tax provisions, the consumer actually pays less for electric service. In the case of electric utilities, accumulated deferred taxes that result from the use of accelerated depreciation are almost universally deducted from the utility's rate base (or reflected as a reduction in the rate of return allowed), which results in lower charges to customers for electric service.

To understand the misconceptions concerning the tax treatment of the industry, it is necessary to understand exactly what happens, and does not happen, to dollars that are collected from customers but not immediately paid to the government as taxes as well as related considerations.

(1) The dollars are invested in electric facilities to better serve the company's customers. If the dollars were not available from this source, they would have to be obtained from investors at a high cost and utility bills would have to be increased to cover the high cost.

(2) The electric company does not earn a profit on the invested dollars that result from use of accelerated depreciation, because it is the well-established practice of regulatory commissions to reduce the utility's rate base for the accumulated dollars or to reflect them as a reduction of the allowable rate of return.

(3) With respect to investment tax credits, the law permits that either the rate base or cost of service be reduced ratably over the lives of the electric facilities which provide the credit.

(4) Deferred taxes are not paid as dividends to the electric company's shareholders. Dividends can be paid only out of profits, and not one penny of the amount collected for deferred taxes is added to profit. Rather, as expressly required by generally accepted accounting principles and by law, deferred taxes are reflected by the utility in special reserve accounts.

(5) The dollars of taxes deferred because of the use of accelerated depreciation are subsequently paid. Rules and regulations of the Internal Revenue Service and the Federal Energy Regulatory Commission and other regulatory agencies require that plant and equipment additions be segregated by year of addition for purposes of computing accelerated depreciation and related tax deferrals. These records clearly show the fact of later payment.

EEI believes that any changes in the tax treatment accorded electric utilities for the purpose of raising revenues would have a detrimental impact not only upon the financial viability of this nation's most capital intensive industry but also upon ratepayers as well.

STATEMENT OF G. ROBIN SWIFT, JR., PRESIDENT, SWIFT LUMBER, INC., ON BEHALF OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

SUMMARY

Timber capital gains treatment is sound, responsive and necessary

Timber capital gains treatment promotes equity among timber owners.

Curtailment of timber capital gains treatment would be unfair to timber owners who relied on its availability.

Timber is a unique investment, the economics of which are relatively unattractive.

There has been a dramatic response in timber management and reforestation since timber capital gains treatment was first enacted.

Substantial new investment is required to meet our nation's future timber needs.

U.S. forest products compete in world markets.

Encouraging the availability of lumber and wood products promotes conservation of the environment.

Misperceptions about timber

The JCT's tax expenditure estimates associated with timber capital gains treatment are excessive and overstate the revenues that would be realized were timber capital gains repealed.

Timber capital gains treatment does not significantly reduce the effective tax rate of the forest products industry—a rate which has been comparable to other industries.

Timber investments yield a marginal rate of return even with capital gains treatment.

I. INTRODUCTION

We appreciate the opportunity to present this statement on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of more than five million forestland owners of all sizes from all regions of the country.

The principal public policy objective of our Committee is the attainment and preservation of equitable federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved. We are submitting this statement in support of timber capital gains treatment.

Timber capital gains treatment was added to the Code by Congress in 1944 because the tax treatment of timber owners prior to that time was inequitable and prejudicial to our Nation's timber resources. Timber capital gains treatment has since been reexamined by Congress in 1954, twice in the 1960's, and three times in the 1970's. Each such reexamination reaffirmed the continued need for its retention.

While not explicitly within the scope of these hearings, timber capital gains treatment may well be considered by the Committee in connection with base/broading options. We thus feel that it is important to address timber capital gains at this time.

II. TIMBER CAPITAL GAINS TREATMENT—SOUND, RESPONSIVE AND NECESSARY

A. Equity among timber owners

Under the specific timber provisions of Section 631, an owner who cuts his timber or disposes of it under a contract with a retained economic interest is eligible for capital gains treatment. It is important to recognize that this section does not apply to a timber owner who makes an outright sale of standing timber. Rather, such an owner is disposing of a capital asset, and accordingly is generally taxed the same as the owner of any capital asset.[1]

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[1] With the exceptions noted in the second paragraph, an outright sale of standing timber gives rise to capital gains treatment, since standing timber is a capital asset under I.R.C. § 1221, unless the standing timber is deemed to be used in a trade or business. I.R.C. § 1221(2). In the latter case, however, an outright sale of standing timber obtains capital gains treatment under I.R.C. § 1231(b)(1), since it is real property used in a trade or business. (Both fee interests in standing timber and long-term harvesting rights are generally treated as real property under state law. *See, e.g.*, 73 C.J.S. *Property*, § 7c, p. 160, § 8, pp. 174–75; 98 C.J.S. *Woods & Forests*, § 2, pp. 688–89; 54 C.J.S. *Logs and Logging*, § 11, pp. 686–88). Note that capital gains treatment

Continued

Prior to the adoption of the specific provisions for timber capital gains in 1944, if a timber owner cuts his timber for sale, he was taxed at ordinary income tax rates on whatever total gain resulted. Thus, such an owner was taxed at a higher rate than if he sold the timber outright and let the purchaser come on his lands to do the cutting.

Similarly, under prior law, if a timber owner cut his timber for use in his business, he was taxed at ordinary income tax rates on both the appreciation inherent in the timber before it was cut and the value added after cutting. For example, a sawmill operator who owned standing timber and cut it for use in his sawmill had to pay the higher ordinary tax rates on both the appreciation inherent in the timber before it was cut and the value added after cutting. Thus, as a practical matter, the sawmill operator who owned standing timber would have been better off selling his timber outright, and then buying logs from another landowner as needed in his mill. In this way, he would obtain capital gains treatment for the appreciation inherent in his standing timber, and would be subject to ordinary income tax on profit attributable to the logging and conversion.

Equity was achieved in 1944 by the enactment of Section 117(k), the predecessor to Section 631 (a) and (b). As a result, an owner who cuts his timber or disposes of it under a contract with a retained economic interest obtains in general the same treatment as an owner who sells his timber outright. This is the proper tax result since the net economic result of each of these transactions is the same.

The specific timber provisions merely provide a means to distinguish the appreciation in timber from the value added to the resulting logs or timber products. The appreciation is taxed at capital gains rates, the same as other capital assets; the latter is taxed at ordinary income rates, the same as other converting or processing profits. In contrast to prior law, which resulted in an incentive for outright liquidations, the present law results in effective tax policy by removing a penalty against holding and managing timber of long-term growth. Thus, the specific timber provisions implement a uniform and consistent tax policy by providing all timber owners with the same tax treatment, regardless of which of the various types of timber transactions are employed.

This treatment is altogether consistent with the underlying provisions of the Code. Real property (including timber) held for investment has always been defined as a capital asset. Since 1942, all real property (including timber) "used in the trade or business," owned for the requisite period and not held primarily for sale or in the ordinary course of business has been uniformly subject to capital gains treatment under what is now Section 1231. The specific timber provisions of Section 631 merely establish equity among all timber owners consistent with existing law. They do this by (1) eliminating the previous discrimination against timber sold under contracts with retained economic interests; and (2) providing those who cut timber for "use in a trade or business" or for sale with a simple way to measure the capital gains inherent in the timber.

B. Commitments made in reliance on long-standing tax policy

Many businesses and individuals planted and managed their timber stands relying on the availability of a moderate timber capital gains tax rate when the timber stand matured. This tax rate is a critical component in the rate of return calculations customarily made prior to undertaking any substantial investment.

A midstream change in the tax rules would be grossly unfair to those timber owners who have reasonably based their investment decisions on continuation of a tax policy which has been the existing law for almost 40 years.

And to change the law only for prospective investments would create, apart from administrative difficulties, significant inequities and competitive distortions between the "haves" and the "have nots."

Moreover, the repeal of timber capital gains would have deleterious effects on those many communities dependent upon harvesting and processing our nation's timber resource. Those communities rely heavily on the timber industry for economic and fiscal support, counting on timber as an important source of jobs and tax revenues.

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under I.R.C. § 1231(b)(1) is available independently from I.R.C. § 1231(b)(2) (relating to Section 631 transactions), since an outright sale of such timber is not covered by Section 631.

Regardless of whether I.R.C. § 1221 or I.R.C. § 1231 applies, capital gains treatment will be available only if the standing timber was held for one year (I.R.C. §§ 1222(3), 1231(b)(1)), and if it was not held primarily for sale to customers in the ordinary course of a trade or business (I.R.C. §§ 1221(1), 1231(b)(1)(B)).

C. Unique nature of timber investments

Absent capital gains treatment, the economics of growing timber continue to be unattractive. This results first from the inherent substantial front-end investments in land and planting costs, the carrying costs, and the 30- to 100-year growing cycle for timber. The effect of these factors is to tie up investments for extended periods without any current returns. Second, the return that is generated is substantially lower than the return available from other types of investments. Third, substantial risks, such as fire, insects and disease, and windstorms, exist with respect to timber. The long-term growing cycle of timber results in an increased exposure to these risks far beyond that of other types of investments. Without capital gains treatment for timber, there would be an unfair bias in favor of other more liquid, less risky investments that receive capital gains treatment.

D. Dramatic response in timber management and reforestation

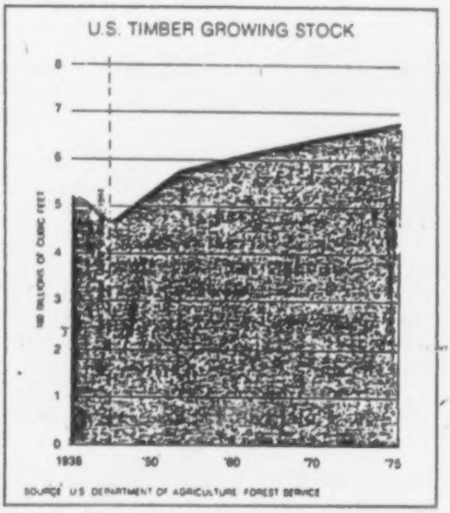
There is probably a no more dramatic example of the direct relationship between tax policy and producer response than that evident in the history of the timber economy throughout the twentieth century.

Before 1944, the year timber capital gains treatment was enacted, the timber resource was in a state of alarming decline: The United States had seven billion cubic feet less timber at the end of every year than at the start. The enactment of the specific timber capital gains rules dramatically reversed that trend.

Since 1944 over 30 million acres of private lands have been planted, compared to only 3 million acres in all previous years. Scientific forest management is now practiced in all regions of the country.

Tables I and II show the impact in terms of timber growing stock annual plantings in private forests:

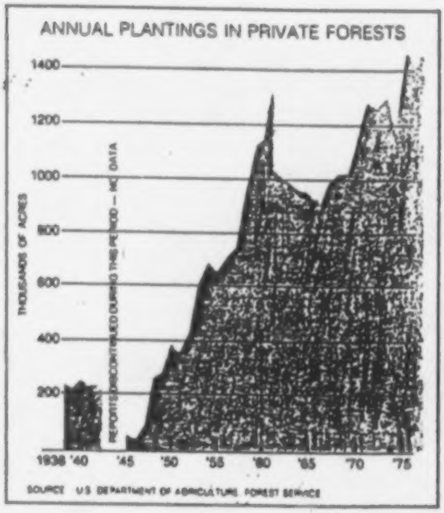
Table I



U.S. TIMBER GROWING STOCK

SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

Table II



ANNUAL PLANTINGS IN PRIVATE FORESTS

SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

E. Substantial new investment required to meet Nation's future timber needs

To satisfy our Nation's future timber needs, a 1980 industry study (conducted in concert with federal and state agencies) determined that approximately $8 to $10 billion in new investments will be necessary over the next decade.[2] Were timber capital gains treatment repealed, such investment would be extremely unattractive.

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[2] Forest Industries Council, Forest Productivity Reports (1980).

The Forest Service estimates that domestic demand for paper and wood products may double by the year 2030 with the demand for paper and wood products climbing from 13.4 billion cubic feet in 1976 to 28.3 billion cubic feet in 2030.[3] Table III summarizes the projected supply/demand situation:

TABLE III.—SUMMARY OF U.S. SUPPLY AND DEMAND FOR TIMBER IN 1976 AND 2030 [4]

Category	Billion cubic feet	
	1976	2030
Total U.S. demand	13.4	28.3
Exports	1.8	1.3
Imports	2.8	4.5
Demand on U.S. forests	12.4	25.1
Supply from U.S. forests	12.4	21.2
Supply/demand balance	0	−3.9

[4] Assumes medium-level demand (see note 3, supra) and price rises, net of inflation, similar to those experienced from late 1950's to mid-1970's.

Source: U.S. Forest Service.

The continuation of timber capital gains treatment is necessary if this shortfall is to be met.

To meet the nation's future forest product needs, timber must continue to be planted today. Unlike mistakes in other areas of tax policy, which can be corrected without long-term effects, an adverse change in timber tax policy will directly result in lost tree growth—a loss which is irreversible even with modern forestry technology. Intensification of future planting efforts will simply not replace the lost timber volume in the time frame in which it will be needed.

F. U.S. forest products compete in world markets

U.S. forest products companies have proven to be exceptional competitors in international trade and there is excellent potential for further improving our position in world markets. However, virtually every industrial country in the free world has recognized the unique risks attendant to timber growing, and has in place special tax incentives to encourage investment in future timber stands. It is irrational for U.S. producers to develop these market opportunities, only to discover that they are at a competitive disadvantage because of parent country tax disincentives.

G. Encouraging the availability of lumber and wood products promotes conservation of the environment

During the extended period of time from planting of timber to maturity, timber growing represents a major commitment to the conservation, recreation and scenic enjoyment needs of the general public. In comparison to many of the products with which wood competes, forest products are produced with relative energy efficiency and structural wood products manufacturing has made great stride in reducing fossil fuel dependency, substituting wood residuals (in addition to those used as raw materials for pulp and paper manufacturing) as fuel. Pulp and paper manufacturing now supply approximately 50 percent of its own BTU requirements, using process residues for fuel, a significant increase in energy self-sufficiency since the early 1970s. The industry's positive conservation, energy, and environmental accomplishments are a recognized matter of record.

III. MISPERCEPTIONS ABOUT TIMBER

A. Overstated joint committee tax expenditure estimates

The Joint Committee on Taxation (JCT) estimates that the tax expenditures associated with timber capital gains are $515 million in fiscal year 1984, $580 million in fiscal year 1985, $675 million in fiscal year 1986, $775 million in fiscal year 1987, and $825 million in fiscal year 1988.[5] These estimates, however, appear to substantially overstate the revenues that would be generated if timber capital gains treatment were repealed.

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[3] In part because of the hazards of making estimates of what is likely to occur fifty years hence, the Forest Service has assumed three alternative economic and demographic scenarios for its estimates. Thus, based on these scenarios, the Forest Service has developed three alternative possible future demand levels—low-level demand, medium-level demand, and high-level demand. The data presented in this testimony depicts the results that will ensue if medium-level demand were to occur.

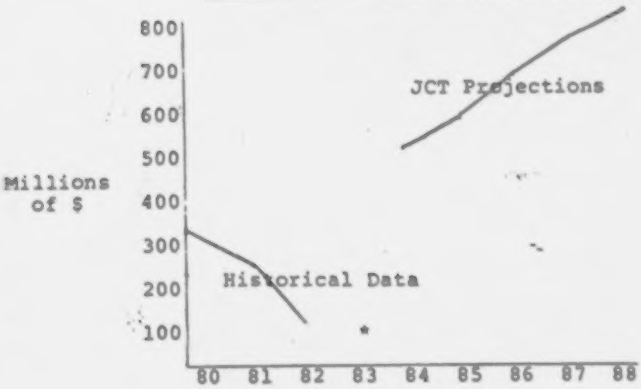
[5] Joint Committee on Taxation, Estimates of Federal Tax Expenditures (Mar. 7, 1983).

Data from a forest industries survey indicates that the tax benefit derived from timber capital gains treatment is signficantly below the JCT projections. We estimate on the basis of this survey data that the industrial sector benefited from timber capital gains treatment by approximately $220 million in fiscal year 1980, $175 million in fiscal year 1981, and $85 million in fiscal year 1982. Using the Treasury Department's estimate that 30 percent of all timber capial gains are attributable to individuals, we extrapolated the total cost of providing timber capital gains treatment: $315 million in fiscal year 1980, $250 million in fiscal year 1981, and $120 million in fiscal year 1982.

In light of this decidedly downward trend, we do not fully understand the assumptions underlying estimates that would indicate a reversal of that trend to the extent that the tax expenditures associated with timber capital gains treatment are projected to be up to three and one-half times the average benefit realized during the past three years. Juxtaposing the results from the last three years against the projections results in the following comparison:

Table IV

REVENUE LOSS ESTIMATED TO RESULT FROM THE REPEAL OF TIMBER CAPITAL GAINS: COMPARISON OF HISTORICAL DATA WITH JCT PROJECTIONS



* Not available

While the timber industry is currently recovering from the recession, the JCT projections can hardly be credible since neither the extent nor the duration of the recovery is known.

The JCT's estimates appear to be based on historical trends that ignore the experience of recent years. Also, the tax expenditure estimates do not take into account the interrelationship between capital gains and other provisions, such as minimum taxes. Thus, the tax expenditure data is an inappropriate basis for estimating the revenues that would be gained from the repeal of timber capital gains treatment and are a poor predictor of the revenue increase that might be expected were timber capital gains repealed.

B. Analysis of Pease-Dorgan Survey

While a survey publicized by Congressmen Pease and Dorgan indicated that five forest products companies had a negative effective tax rate for 1981, the survey results are misleading. One unfamiliar with the industry might assume that timber capital gains treatment was the major contributor to the low rate, but this is simply not so. Almost half of the low effective rate was, in fact, caused by accelerated depreciation and investment tax credit (many of the companies being in excess credit situations) resulting from significant new investment in plant and equipment even during these difficult economic times. While the companies still realized timber capital gains benefits, the relationship of such benefits to the negative effective tax rate is summarized as follows:

	Percent
Nominal tax rate	46.0
Accelerated depreciation and investment credit	(27.3)
Other adjustments (nontimber)	(21.0)
Capital gains	(6.7)
Effective tax rate	(9.0)

The year 1981, with the severe recessionary impact, was not a representative year for the timber industry. In more typical years, the timber industry's effective tax rate is not dissimilar to the effective tax rates of other industries. A more complete discussion of an analysis of the Pease-Dorgan survey is contained in Appendix A.

C. Marginal rate of return

Even with capital gains treatment, the return from investment in timber is marginal. Federal Trade Commission reports indicate the return on equity from paper and allied products for the period 1960–1979 to be 11.1 percent, compared with a return of 12.5 percent from all durable and nondurable goods produced. Although separate numbers for timber and wood products were not maintained by the Federal Trade Commission later thasn 1973, the comparable figures for 1960–1973 show a similar pattern.

IV. CONCLUSION

Timber capital gains treatment has for almost 40 years provided a powerful incentive for proper management of our nation's timber resources. By providing identical tax treatment to comparable timber dispositions, the specific timber capital gains provisions promote equity among all timber owners.

Without a tax policy that encourages the proper management of our timber resources, the timber needs of future generations will not be met as the required investment will not be made. Timber, which is subject to unique risks, has historically had a rate of return below that of other investments. The specific timber capital gains rules merely enable timber to compete for investment dollars with other, more liquid investment opportunities.

We believe that the record amply demonstrates the continued need for timber capital gains treatment.

Appendix A.—Analysis of Pease-Dorgan Survey Results

The Pease-Dorgan survey, published in the Congresional Record last December, indicated that five paper and wood products companies had a 1981 effective tax rate which was negative for both worldwide income and U.S. income. An analysis of these five companies' effective tax rates disclosed that while the five companies did receive significant capital gains benefits, timber capital gains treatment simply was not the major contributor to the low rate.

The analysis done using the approach employed by the Joint Committee on Taxation revealed that the most significant cause of the low effective tax rate was the five companies' substantial new investment in plant and equipment. Excess depreciation reduced the companies' effective tax rate by 15.7 percentage points with the investment tax credit further reducing the rate another 11.6 percentage points, 27.3 percentage points in the aggregate.

From this analysis, it is clear that the capital gains tax contributed in only a modest way to the 1981 negative effective tax rate of the five companeis as it reduced their taxes by 6.7 percentage points. In this regard, it should be emphasized that the timber capital gains rate cannot result in a negative effective tax rate since the rate on capital gains is 28 percent.

A single year's data, however, indicates little. As Congressman Pease stated when introducing the Pease-Dorgan survey into the Congressional Record:

"While raw numbers are of little interest by themselves, tracking their year-to-year changes in future tax studies will allow us to see growth or decline of industries and their tax contributions to the operation of our country."

Thus, we computed the effective tax rates of these five companies over the period 1978 to 1981, and analyzed their contributing components. This analysis is presented on page 4.

The analysis also indicates that 1981 was not a typical year for the five companies. Rather, the negative tax rate in 1981 was the result of significantly lower earnings because of the recession, at a time when large capital projects were coming on stream. This combination of events—relatively low earnings and high depreciation deductions and investment tax credits—produced net operating losses and investment tax credit carrybacks resulting in refunds of taxes paid in prior years, i.e., negative taxes in 1981. For the remaining years, the five companies had a positive effective tax rate although the rate for 1980 was low, showing marked similarity to 1981. For the more representative years 1978 and 1979—prior to the recession—the five companies' average effective tax rate was 23.6 percent.

In summary, the analysis indicates that timber capital gains had little effect on the 1981 effective tax rate; that the negative effective tax rate was peculiar to the circumstances of 1981; and that the effective tax rate of the five forest products companies in a normal year approximates the 1981 effective tax rate of the average of all industries shown in the Pease-Dorgan survey, 25.1 percent.

ANALYSIS OF EFFECTIVE TAX RATES FOR FIVE PAPER AND WOOD PRODUCTS COMPANIES [1] 1978–81

Tax year	Nominal tax rate	Other adjustments to nominal rate				Adjustments for capital gains	Pease-Dorgan effective tax rate [3] (Col. 1−5−6)
		ITC	Tax depreciation over book depreciation	Other adjustments net [2]	Total col. 2+3+4		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1978	48.0	(4.4)	(5.4)	(2.7)	(12.5)	(10.0)	25.5
1979	46.0	(5.4)	(3.7)	(3.6)	(12.7)	(11.6)	21.7
1980	46.0	(10.4)	(8.2)	(16.6)	(35.2)	(7.0)	3.8
1981	46.0	(11.6)	(15.7)	(21.0)	(48.3)	(6.7)	(9.0)

[1] Computed by a methodology comparable to that used by the Joint Committee on Taxation in "Taxation of Banks and Thrift Institutions" (Mar. 9, 1983). The five companies are those selected by the Pease-Dorgan Survey.

[2] Including Pease-Dorgan adjustment; excluding capital gains.

[3] Computed in accordance with Pease-Dorgan study, Congressional Record (Dec. 20, 1982) at H. 10545.

Note.—1981 effective tax rate for the average of the 22 industry groupings in the Pease-Dorgan Survey is 25.1.

Statement of Henry W. Bloch, President, H & R Block, Inc.

Mr. Chairman and members of the committee, I appreciate the opportunity to submit this statement for the official record of your July 19, 1983, hearing on your efforts to improve tax compliance and to increase revenues.

We recognize the magnitude of the tax gap problem and its implications for our tax system and our budget deficits. We think the penalty provisions of last year's far-reaching Tax Equity and Fiscal Responsibility Act (TEFRA) will help narrow the gap. We think that two other approaches are necessary to narrow the tax gap even more. One, which is obvious and requires no elaboration, is to increase the Internal Revenue Service resources devoted to compliance and enforcement programs. The second approach is somewhat innovative and simple but worth your serious consideration.

As you know, a deduction for tax return preparation expenses is available to those taxpayers who file returns claiming itemized deductions. This encourages taxpayers to seek professional tax help, thereby helping them comply with the tax laws. But a similar tax assistance benefit is not available to those who do not itemize deductions—usually lower income taxpayers and those who are least able to understand and comply with the tax laws. Millions of our clients view this as a glaring inequity. It undoubtedly is one contributing factor to the non-compliance problem which you are addressing in this hearing.

A fair solution to this inequity while at the same time helping all taxpayers to comply with the tax laws is to grant a small tax credit to all taxpayers for tax preparation expenses. Any costs exceeding the small credit should be deductible, as now allowed by those who itemize deductions.

It is by now universally recognized that voluntary compliance is vital to the health of the income tax system and that the system be perceived by all taxpayers (those with smaller incomes as well as those with larger incomes and those who understand the ever-more-complex law and those who don't understand it) as one which has the fundamental objective of fairness and evenhanded treatment of all taxpayers. It is unjust and incomprehensible to the taxpayer who files the two-page Form 1040A or who files a Form 1040 but does not itemize, that he or she is not entitled to a tax benefit for the expenses incurred in having his or her return prepared by professional preparers.

Quite aside from the inequity of the situation, practical compliance advantages to the government should result from an amendment to the Internal Revenue Code providing for such a benefit. Some, but not all, of the compliance and other related advantages would seem to be as follows:

1. Assistance from qualified tax return preparers will help insure the preparation and filing of returns that generally are, and should continue to be more accurate than those prepared by taxpayers themselves. A credit will encourage taxpayers to seek assistance from qualified preparers which should improve compliance and the functioning of the entire system.
2. The success of the American tax system is dependent to a great extent on voluntary compliance. Such voluntary compliance would be enhanced as a result of the adoption of this benefit with more revenue received by the government including some reduction in the tax loss from the so-called underground economy.
3. If tax withholding on interest and dividends becomes a fact, or if additional compliance requirements and back-up withholding is legislated, taxpayers will have heavier compliance burdens.

The assistance of professional preparers should decrease the compliance burden of taxpayers and result in fewer errors on returns filed, thus also decreasing the IRS processing and compliance efforts.

4. Such a credit which encourages taxpayers to use qualified tax return preparers should have the additional benefit of providing peace of mind to taxpayers that they have complied with the law—not under- or over-reported their tax obligations—and that if and when audited, they would be accompanied by a qualified individual with supporting data.
5. Since the provision for the new credit should encourage taxpayers to seek private sector assistance in lieu of visiting or telephoning offices of the Internal Revenue Service, it would help reduce the IRS taxpayer assistance budget and make more resources available for compliance and enforcement activities.
6. Public confidence in the tax system would increase, especially on the part of the lower income taxpayers who do not understand the law and therefore may not be able to comply with it. They are concerned with obtaining reliable advice but often cannot afford to to do so. Since many of these taxpayers view the Internal Revenue Service as an enforcement agency, to them information received from the IRS is therefore suspect. The only real choice for many of them is a reliable tax return preparer.

In summary, public policy reflected in the Internal Revenue Code for many years is intended to encourage the use of paid tax preparation assistance for itemizing taxpayers who are usually higher income taxpayers. The tax savings from such a policy until recently were worth as much as 70 percent of the fees paid to preparers and are worth as much as 50 percent under current law.

Such a policy should be applicable to *all* taxpayers. It may even be argued that from a public interest standpoint it is even more important to have the policy apply to lower income taxpayers since they are frequently the ones who find it difficult to understand and comply with the tax laws, are uncertain about what income is reportable and taxable, are unable to deal with the forms themselves and can least afford to pay for tax preparation help. Millions of individuals file forms 1040A or 1040EZ and numerous others do not itemize deductions. They deserve the same benefit and incentive to seek competent tax preparation assistance from the private sector as the itemizing taxpayer.

A reduction in the tax compliance burden for non-itemizing taxpayers and equal access to tax preparation assistance for all taxpayers would be best achieved by a tax credit for income tax preparation fees.

I respectfully request that you introduce a bill which would allow a $25 tax credit for everyone regardless of the tax form used with any expenses incurred for tax preparation fees over the $25 credit being allowed as a deduction for those who itemize deductions. This would help substantially the masses of taxpayers to comply with our tax laws without giving any significant added benefit to those with high incomes. The relatively minor added tax expenditure resulting from this credit would much more than be offset by the additional revenue recovered from improved compliance.

I would be pleased to discuss this in greater detail with you or a member of your staff.

STATEMENT OF C. LOWELL HARRISS, PROFESSOR EMERITUS OF ECONOMICS, COLUMBIA UNIVERSITY; EXECUTIVE DIRECTOR, ACADEMY OF POLITICAL SCIENCE; ECONOMIC CONSULTANT, TAX FOUNDATION, INC.; ASSOCIATE, LINCOLN INSTITUTE OF LAND POLICY

Revenue increases are required by the First Concurrent Resolution on the Budget for 1984. Large deficits will present problems. So will the taxes due under present law—without any increases in rates or coverage. Is it not the expenditures, however, that present the most serious of problems?

The apparently inexorable rise of Federal spending results from forces well known to members of Congress. Americans have various aspects to their lives, and in one aspect or another—or several—we seek "good things" obtainable from Federal spending. Such spending commands resources for governmentally provided goods and services; or resources are used as the recipients of transfer payments, such as Social Security, spend them for goods and services. In an important sense it is the real (resource-using) aspect of expenditure rather than the taxes that most truly represent the costs of government. But what warrants attention for the present purposes, however, is not the distinction between spending and revenue-raising, but a possible relation between them.

Revenue devices can help to reduce the demand for (rising) expenditures. Not hugely. Not immediately (to any significant degree). Not as a centerpiece of any deficit-reduction program. But usefully. Some revenue measures can affect the budget deficit not only by bringing in revenue but also by reducing somewhat the demand for government spending.

The "revenue raisers" of the market place are prices. They balance quantities demanded and quantities supplied. Most government activities cannot be marketed at prices. Here is one reason why the "demand" for Federal spending rises so stubbornly: The pricing process of the market does not operate as a restricting device. The beneficiary, the voter, and those who speak for "client groups" naturally press for programs whose fruits, the "good things," are free to the recipient. The merits cannot be denied. Yet other "good things" must be foregone to permit the provision of those financed by government.

Where charges, prices, or an equivalent can be employed by government, their greater use deserves serious attention—not only for the revenue obtainable but also as a means of restricting somewhat the demand for governmental spending. A two-pronged effect will result—more revenue, less spending. Although the immediate effect on Federal spending would probably be "lost in the shuffle," change would be in the direction desired to reduce the deficit. Even over time the maximum feasible restraint on expenditure growth could hardly be large. Yet it could do something.

Proposals for greater Federal use of charges and pricing have led to actions in recent years. (Those of us who subscribe to Federal government publications have become aware of substantial increases in their prices.) Review of potentials should continue and could include explicitly the possibilities of curbing growth of spending as well as obtaining revenue.

Members of Congress know very well indeed the pressures of those who want "good things" to be paid for by others. The economic as well as the political considerations of charging can be complex. When facilities already exist, there is merit in pricing at out-of-pocket (marginal, incremental) cost rather than at full average cost, which includes already sunken costs. Yet even for facilities already existing there may well be good reason for scrutiny of the role of charges to help control expenditure as well as to bring revenue.

More important, in planning on new projects and programs—whether to undertake the construction of physical things (perhaps an irrigation or transportation project) or to establish or enlarge an entitlement program—the spending side of the budget can be influenced by provisions for getting revenues from beneficiaries. In projecting quantities demanded, would not better results come from decisions that rest upon estimates of full-cost charges than on those projections that assume some "low" or "almost-free-good" pricing? "Yes"—often but not always.

Revenue-raising committees of Congress do not, of course, have jurisdiction that embraces the complete range of the issues involved in my proposal. Most actions of significant potential would require years for full implementation. The largest reasonably realistic numbers (total net effects on budgets) would be modest in relation to deficits now projected.

Yet, some push, some impetus, some explicit effort could, I believe, do more than bring more funds. Revenue-raising measures could also help to restrain the rise of spending.

STATEMENT OF THE HEALTH INSURANCE ASSOCIATION OF AMERICA

This statement is in behalf of the Health Insurance Association of America. The HIAA is a trade association of approximately 320 companies which together write over 85 percent of the country's commercial health insurance.

Mr. Chairman, the Administration has asked Congress to levy a tax on employee health plans as part of its F.Y. 1984 legislative program.

The Administration has further proposed, in testimony to the Senate Finance Committee on April 27, and in further testimony to this Committee, that the employee health tax, not yet enacted, be increased to finance grants to the states for health insurance for the unemployed, although insisting that the purpose of the tax is to contain rising health care costs, not raise revenue.

The health insurance industry opposes this proposal as discriminatory, unfair, and one that will do nothing to stop health-care-cost inflation, nor will it raise the revenue suggested as labor-management negotiations rearrange the employee benefit package.

Among the arguments against such a tax are the following:

It penalizes older workers.—Elderly groups tend to use health care more frequently than younger, healthier workers. Hence, the cost of health insurance for a group which includes more than the average number of older workers not only will be higher but could discourage many employers from hiring the older worker. Under the Administration proposal, these groups will be adversely affected by a cap, while younger groups with similar coverage may not be taxed.

It penalizes those in hazardous, high-risk occupations.—Some groups, such as iron workers or coal miners, are usually considered a higher "risk," and are typically charged higher health insurance premiums. These groups could be unfairly taxed while other groups with similar coverage—such as clerical workers—would be unaffected.

It is a form of "double taxation".—The Health Insurance Association of America estimates that Medicare and Medicaid payment practices resulted in $7.9 billion being shifted to patients covered by private health insurance in 1983 to make up for government underpayment to hospitals. For the government to shift these costs to the private sector and then put a tax on the resulting higher insurance premiums is patently unfair.

It unfairly affects certain geographic areas.—The cost of health care is higher in some areas, such as large metropolitan cities. A single national tax cap does not take geographic differences into account, and thus would particularly penalize those in high-cost areas. Conversely, it would allow the tax-free purchase of much more generous benefit plans by those in low-cost areas.

It could result in reduced coverage for preventive care services.—As employees scramble to reduce their overall premium rates, essential preventive care services such as dental care, vision care, mental health benefits, and alcohol and drug abuse services may be dropped from benefit plans. Dropping these benefits does nothing to reduce hospital costs, and in the end may have the opposite effect.

Mr. Chairman, all of those in the private sector who have the most to gain from effective hospital cost containment—the employers, the unions, the insurers—in essence, all of those in the private sector on the paying side of the equation—say the employee health tax will be ineffective in curbing rising costs and are opposed to its enactment. Those who have the most to gain by its failure to work, i.e., the health providers, say it will work to de-escalate hospital inflation. However, it is a fact that the medical expense people fear most is hospital expense, and it is hospitalization insurance that will be the last, and least, effected by this proposal.

On this point, Mr. Chairman, I would like to call attention to the Rand study on health care costs published in November 1982, a study often referred to by the health tax proponents as demonstrating the efficacy of the health tax in reducing health costs, a conclusion to which we obviously take exception.

The study states, in any event, that while the increased cost of employee health insurance resulting from the tax would reduce the over-all amount of health protection available:

"In fact, people would probably not reduce their insurance coverage uniformly but would follow some simple principles in making selective reductions. Just as insurance was historically first chosen to cover the highest risk services (e.g., hospitalization) and only later extended to cover lower risk services (e.g., physician office visits, dental care, psychiatric visits), retrenchment in coverage would probably follow similar patterns. Dental care, ambulatory care, drugs, and similar services would probably become uncovered or, at least, covered only with very large yearly deductibles of perhaps $500 or more, rather than currently typical deductibles of $150 to $200. In terms of effects on aggregate medical care market demand, most purchases of these services would be uninsured. Hospital insurance coverage would probably be least changed, because the financial risks are greatest for hospitalization."

The study raises another concern. It points out that while a "typical proposal" for taxing employees on half of employer-paid contribution could reduce hospital use by $7.6 billion, the hospitals could recover more than $5 billion "by raising prices charged the remaining patients, the government, and insurers."

Well, with the passage of the Social Security Amendments of 1983 putting Medicare on the new DRG-prospective basis, set by HHS, it won't be the government hit by the new round of higher prices—it will be the rest of us.

The end result will be health insurance that is more expensive, people having less protection, hospital prices higher for those that need their services, and hospitals getting the same amount of revenue to cover their over-all fixed operating expenses.

In essence, as a hospital cost containment device, the employee health tax is a meat-axe that misses its mark.

The same study concludes on another cautionary note, "Effects on consumers' health status are as yet unknown but will have considerable effect on the desirability of such changes in public policy."

We believe that encouraging people to cut back on preventive services will have a detrimental effect on consumers' health status.

The most sensible approach to keeping hospital costs under control is prospective pricing reform that applies to all patients, not just Medicare patients. Rising costs are not just a Medicare-Medicaid problem but a national health care problem as well. A prospective all-patients system will force cost-saving incentives into the structure of hospital payments and operations and will have many times the impact of the band-aid approach of taxing workers' health insurance premiums.

We are beginning to see that prospective payment systems that include all-payers, include Medicare, now in place in four states, can work. There is no reason why the Congress should try the untested theory of taxing health insurance premiums—and every reason why it should not.

Attached to this statement is a resolution subscribed to by a number of organizations who also wish to be recorded as opposed to the employee health tax.

Whereas a tax on employee health benefit plans would be discriminatory and unfair in application and ineffective as a means of slowing the rising cost of hospital care, we urge the Congress to reject any tax on employee health benefits.

Health Insurance Association of America, American Dental Association, National Association of Casualty and Surety Agents, International Association of Machinists and Aerospace Workers, Caterpillar Tractor Company, Small Business Council of America, Inc., International Brotherhood of Teamsters, Professional Insurance Agents, Society of Professional Benefit Administrators, Aetna Life and Casualty, New York Life Insurance Company, Insurance Association of Connecticut, Peoples Life Insurance Company, Alliance of American Insurers, American Council of Life Insurance, The Travelers Insurance Company, American Optometric Association, American Psychiatric Association, American Federation of Teachers/Federation of Nurses and Health Professionals, National Education Association.

U.S. Chamber of Commerce, Blue Cross/Blue Shield Associations, Group Health Association of America, Laborers International Unions of North America, AFL-CIO, Health Resources Corporation of America, Family Health Program (FHP, Inc.), Association of Private Pensions and Welfare Plans, CIGNA, Transamerica Occidental Life Insurance Company, American Dental Hygiensts' Association, Kemper Group, Independent Insurance Agents of America, American Dental Trade Association, National Association of Private Psychiatric Hospitals, Delta Dental Plans Association, American Speech-Language-Hearing Association, National Association of Insurance Brokers, National Association of Life Underwriters, National Mental Health Association, American Hotel and Motel Association.

Highway Users Federation,
Washington, D.C., July 20, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

Dear Mr. Chairman: The Highway Users Federation is a national, longstanding coalition of businesses, industries and associations working to make America's highway transportation systems safer and more efficient. Our members are the chief users of highways and the main providers of highway transportation products and services.

We appreciate the opportunity to comment on methods to meet the revenue reconciliation instruction of the fiscal year 1984 First Concurrent Budget Resolution. We hope our comments will be incorporated into the formal hearing record.

Our members oppose the Administrtaion's proposal to reduce the deficit by an excise tax on oil because: (1) it is inequitable; (2) it preempts the nation's dedicated funding source for highways; (3) it focuses deficit-reduction strategies too narrowly; and (4) it will adversely affect the economy in general.

Taxes for general public purposes should have the widest possible base and should fall equitably among taxpayers. If an energy tax is needed as part of a larger tax package, it should be fairly imposed on all energy sources. An oil excise tax does not provide this equity.

There are vast geographical inequities in an oil tax.—Taxing petroleum for general government purposes distorts the responsibility of Americans in different regions of the country to shoulder equally the responsibility for the federal deficit. Under an oil tax, consumers in the West, who use more gasoline than the national average, would bear a disproportionate share of the financial burden. Americans in Wyoming typically drive over twice as much as people in New York. There is no logic in making a Wyoming family bear a greater burden of the federal deficit than a family in New York. The tax will pit Westerners against Easterners and urbanites against rural and suburban dwellers.

From the highway user perspective, petroleum use is already heavily taxed—in some states at more than 20 percent of value—by federal and state taxes. Highway users do not have the option of shifting to other kinds of fuel and must use oil regardless of the cost.

There are gross social inequities in an oil tax.—Taxing oil, particularly gasoline, is regressive because it hits hardest those least able to pay. Because the tax is regressive the social cost will be exceedingly high. A 1977 U.S. Department of Transportation study shows that 80 percent of Americans earning less than $5,000 a year commute to work by private motor vehicles. These citizens would suffer most under an oil tax.

Inequities also arise from the way government administers oil taxes.—Special treatment for some users always accompanies consideration of an oil tax. The history of the Mandatory Oil Import Program in the 1960's and the price and allocation control programs in the 1970's demonstrate this. For example, the U.S. Department of Energy's "entitlements program" under price controls was intended to equalize crude oil costs between refiners. But special treatment and exemptions were used to favor certain classes of refiners and users of heating oil. Similarly, President Carter's proposed oil import fee was intended to be passed through entirely to gasoline. Special treatment and exemptions from an oil excise tax ultimately would be granted to various classes of consumers. This pattern of tax implementation means the burden would fall only on certain groups.

An oil tax would have a direct and damaging effect on highway transportation.—New taxes should not disrupt the well-established and accepted linkage of user charges to public services, such as those provided in state and federal highway trust funds. An excise tax on oil for general fund purposes would effectively preempt the funding source that since 1919 has been largely reserved for highways in the states. At present, motor fuel taxes at both the state and federal levels enjoy strong public support because they are clearly and correctly perceived as user charges imposed for the construction and upkeep of our nation's roads and are generally dedicated to highway trust funds for that purpose.

Evidence of public support for highway-earmerked fuel taxes can be seen in the states. Contrary to the pattern of state tax limitation in recent years, state highway user charges have been widely and substantially increased to deal with serious road problems. In the coming years, states will seek further fuel tax increases to match increased federal road funding from the nickel-a-gallon fuel tax hike. So far this year, 17 states have passed motor fuel tax increases.

You can't have a first-class economy with a second-class road system. Highway user charges have traditionally paid for roads. Energy taxes that undermine dedicated highway user charges will create long/term problems for America's highway transportation and economic vitality.

Over-reliance on a single-product tax has proven unwise government policy in the past.—The so-called "windfall profits" tax provides a recent example. In 1980, income from that tax was estimated to be $227 billion over a ten year period. Because of conservation, worldwide recession and falling oil prices, the revenue projection has been scaled down to $75 billion, a $152 billion miscalculation. Such tax schemes do not solve the deficit problem, they contribute to it.

A $5 per barrel excise tax would have an immediate, sizable and negative effect on the U.S. economy in general.—Projections using the Date Resources, Inc. model estimate that $5 per barrel excise tax imposed this month would produce the following results in 1984.

Consumer prices would be 1.2 percent higher than otherwise expected.

Real GNP would be .8 percent lower than currently projected.

Federal expenditures would rise by $5.8 billion.

Unemployment would increase by 300,000.

The major argument for an oil tax is to reduce the deficit. But the net effect is uncertain. Since the tax would depress the overall economy, revenues from traditional sources such as income taxes would drop, while government entitlement expenditures would rise to assist those Americans added to the unemployment rolls.

Sincerely,

PETER G. KOLTNOW,
President.

STATEMENT OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

This statement is also presented on behalf of the following: American Association of Petroleum Landmen; Arkoma Basin Independent Gas Producers Association; California Independent Producers Association; Eastern Kansas Oil and Gas Association, Inc.; Illinois Oil and Gas Association; Independent Oil and Gas Association of West Virginia; Independent Oil Producers Tri-State, Inc.; Independent Petroleum Association of Mountain States; Independent Petroleum Association of New Mexico; Indiana Oil and Gas Association; Kansas Independent Oil and Gas Association; Kentucky Oil and Gas Association; Liaison Committee of Cooperating Oil and Gas Associations; Louisiana Landowners Association, Inc.; Louisiana Association of Independent Producers and Royalty Owners; Michigan Oil and Gas Association; National Stripper Well Association; New York State Oil Producers Association; North Texas Oil and Gas Association; Ohio Oil and Gas Association; Oklahoma Independent Petroleum Association; Panhandle Producers and Royalty Owners Association; Pennsylvania Grade Crude Oil Association; Pennsylvania Oil and Gas Association; Permian Basin Petroleum Association; Royalty Owners and Independent Oil and Gas Producers Association of Arkansas; Tennessee Oil and Gas Association; Texas Independent Producers and Royalty Owners Association; Virginia Oil and Gas Association; and West Central Texas Oil and Gas Association.

The Independent Petroleum Association of America is a national organization of some 7,000 independent oil and natural gas producers in every producing area of the United States. IPAA, together with the twenty-nine unaffiliated oil and gas associations listed on the cover page, represent virtually all independent producers and thousands of royalty owners in the United States. We are grateful for this opportunity to present our views on proposals to raise revenues in connection with the hearings held July 20 and 21, 1983. We respectfully request that this statement be made a part of the permanent record of these hearings. On May 5, 1983, IPAA presented to the Subcommittee on Oversight of this Committee a comprehensive statement discussing all of the significant present tax provisions specifically related to domestic oil and natural gas producers. Accordingly, we will not repeat what was stated then but incorporate here by reference the record of those hearings.

Like most Americans, we are greatly concerned about the enormous budget deficits currently being projected throughout the foreseeable future. Deficits of this magnitude if allowed to continue unchecked are, in the long run incompatible with the accumulation of sufficient private capital to fund sustained economic recovery. This budget scenario is not, however, a justification for imposing new energy tax schemes. Any new taxes, and especially additional taxes on energy, will have a chilling impact on the economic recovery.

Proposals to comply with the budget resolution's call for $73 billion in new tax revenues have included new energy taxes in the form of either a new tax on both domestic and imported oil or a consumption type tax. Also proposed are elimination or reduction of such important tax incentives as percentage depletion and the expensing of intagible drilling costs. Reducing the massive budget deficits can only be accomplished by thoughtful restraint in spending. Approaching our nation's energy policy with a view only toward the revenues which can be extracted from producers is short-sighted and illogical.

Unreasonable taxation of energy producers is self-defeating. It reduces energy development and production and thereby increases our dependence on more costly alternatives including imported oil and natural gas. This in turn lowers general economic activity and ultimately reduces revenues to the government. This cycle becomes obvious when import fee proposals are analyzed as a revenue measure. Although such proposals will increase revenues in the short term, this positive impact is largely an illusion. Increasing energy costs through such a tariff will reduce general tax revenues from commercial enterprises as their taxable income is lowered by increased costs but, more importantly, federal revenues will be negatively impacted by the effect of the tariff on the general economic recovery. The cycle is, however, not yet complete. A crude oil tariff will directly and permanently increase the general level of prices for goods and services and permanently increase the consumer price index and implicit price deflator which serve as the base for the indexation of payments under so many of our programs. Therefore, as a revenue measure, crude oil import fees would cause grave disruption with no true incremental benefit.

As energy policy, the proposals for an import fee are equally flawed. The results of the last thirty months should clearly demonstrate that the marketplace works in setting price levels far better than government price ceilings or artificial levies. Import tariffs would quickly force artificial situations and create great pressure for exemptions and entitlements. For example, should non-OPEC imports receive the same treatment as OPEC production? Should Western Hemisphere production be taxed the same as other areas? Should imports for the Strategical Petroleum Reserve be exempt? Should home heating oil be exempt? Should all refiners have equal access to domestic production which, presumably, would be untaxed and, therefore, a lower cost feedstock? As these questions are answered in order to achieve equity or further desired social goals, the likelihood of significant market distortions are increased and the resulting distortions are magnified. As recent experiences demonstrate all too clearly, such distortions quickly result in the establishment of government programs to correct the imbalance, which lead to the growth of new bureaucracies. Bureaucratically conceived and administered entitlement and allocation controls follow quickly. As energy policy a crude oil import fee is both counterproductive and wasteful of the resources of the government. Your attention is directed to Exhibit "A" hereto, a statement of IPAA Import Tax Policy adopted May 26, 1983.

We also believe it appropriate to restate for these hearings a portion of statements made in May to the Subcommittee on Oversight. U.S. tax policy has been guided by a desire to tax all enterprises in a manner which reflects their unique characteristics. The option to currently expense intangible drilling and development costs has existed under the Treasury regulations since the inception of the income tax although it was not formally incorporated into the statute until 1954. These early regulations recognized the unique risks inherent in the exploration process and provided, in general, that costs which had no salvage value could be currently charged to expense. Recognition of depletion has a similarly lengthy history. When the 16th Amendment authorized the tax on "incomes," Congress was careful to distinguish between capital and income. Statutory depletion was adopted as a means to recognize consumption of a diminishing physical asset as it is removed or produced from the ground.

Percentage depletion is a highly efficient incentive mechanism. The effectiveness of percentage depletion has been widely recognized and it is applicable to some 105 different minerals. For oil and natural gas producers it is an important tool for generating cash flow from internal operations to finance future exploration drilling. Its availability is especially important in a time of unstable and declining prices.

The option to deduct intangible drilling costs and the recognition of depletion are not the result of congressional favoritism to a special class of taxpayer. These provisions have endured through seventy years of economic change only because they make good sense. These provisions, although perhaps imperfect, exist in recognition of the need to provide incentives for exploration and development of crude oil and natural gas. These provisions are accomplishing this and the reasons for maintaining tax incentives for oil and gas producers are just as compelling today as when those incentives were first enacted.

Principals for a sound energy tax policy are set forth in Exhibit "B" hereto. Generally, energy tax provisions must not be based on short-term deficit, budget and revenue considerations, but on meeting our energy goals over the next 15 years and into the long-term. When evaluated against such a standard we see no merit in the revenue proposals now being discussed before this committee.

EXHIBIT A.—IPAA IMPORT TAX POLICY

Protecting the economy and national security against an overdependence on foreign produced energy is in the national interest. Actions to prevent such overdependence are a legitimate concern of the federal government warranting, under certain circumstances, intervention in the marketplace. However, policies and actions by the federal government in this area should not involve use of tax measures.

Imposition of any tax on imported crude oil is unlikely to be accomplished without some increase in tax on domestic production. Any increase in tax on domestic production, for whatever reason, will be counterproductive reducing both future domestic production and general economic activity. Such actions will, in the long-term, increase rather than reduce dependence on imported energy.

All proposed forms of an import fee carry the probability of significant market distortions. Such distortions result in artificial entitlement and allocation programs which only compound, rather than solve, the problems.

Measures to control overdependence on imported energy are unrelated to issues concerning federal deficits. Government should not attempt to reduce budget deficits through taxes on imported energy or through any energy related taxes. Reduction of budget deficits should be accomplished by reduced spending.

General revenue measures should be broad based, not narrowly directed at one industry or a few taxpayers.

Tax provisions affecting the energy industry must be designed with the primary objective of increasing domestic energy production, rather than as a means of raising government revenue or benefiting one segment of industry at the expense of another.

Energy tax provisions should be designed to: Extend the economic life of existing producing properties; encourage development of discovered but undeveloped high-cost reserves; stimulate investment in exploratory drilling to expand produceable reserves; permit use of internal cash flow for maintaining existing operations; attract investment of risk capital from outside the petroleum industry; and recognize the ever rising costs of replacing energy supplies currently consumed.

Energy tax provisions must not be based on short-term deficit, budget and revenue considerations, but on meeting our energy goals over the next 15 years and into the long-term. This requires that specific energy tax provisons have a substantial degree of continuity so that both explorer-producers and investers will have the degree of certainty necessary to permit long-range planning and execution of business decisions.

A key ingredient in the successful development of our nation's oil and natural gas resources is the multiplicity of effort of thousands of individuals and firms each striving for success under a free economic system that recognizes and rewards both the risks and successes of private enterprise. Consequently, energy tax provisions must encourage new participants into the search for oil and natural gas without penalizing those who have previously accepted the challenge.

Provisions intended to accomplish these objectives must take into account certain basic characteristics of oil and natural gas exploration and development, i.e.: Exploration for and development of crude oil and natural gas are both capital intensive and high risk; the long lead times before investment generates significant return compounds both the risk and capital requirements; unlike most industrial enterprises the successful ventures (producing wells) must not only be self-sustaining, they must also pay for the unsuccessful ventures (dry holes); and attracting investment in petroleum exploration and development must compete with other investment opportunities, many with equal or higher potential rates of return, but none with the high risk of wildcatting.

Achieving an acceptable level of energy independence over the next decade will require investment of unprecedented amounts of capital. Positive energy tax provisions are urgently needed to attain this.

STATEMENT OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS, SUBMITTED BY ROBERT B. AIKENS

SUMMARY

The International Council of Shopping Centers urges the Congress not to change any provisions of ACRS, or any other provision of the tax law affecting business investments, for the following reasons:

A. Fifteen years is a reasonable recovery period for structures compared to the law prior to the enactment of ACRS. While the Treasury useful life guidelines for various structures were longer than 15 years, the actual useful lives of structures were much closer to 15 years, in part, because of the use of the component method of depreciation.

B. Fifteen years is a reasonable recovery period for structures compared to the benefits given other assets under ERTA and TEFRA. Such treatment does not permit taxpayers to obtain tax treatment which is more favorable than immediate expensing of the costs associated with the construction of structures.

Economists have found that the tax law has historically biased investments away from structures by providing lower effective tax rates for other assets. This bias was increased under ERTA, and, although the increase was diminished by TEFRA, the tax law continues to be biased against investments in structures. Any reduction in the cost recovery allowances for structures will again increase this bias and the resulting misallocation of capital. The economic inefficiency caused by this misallocation of capital has been estimated by the Congressional Research Service to cost our nation's economy billions of dollars a year.

C. According to a Coopers and Lybrand model developed for the National Realty Committee, the proposal of the Congressional Budget Office to increase the recovery period for structures from 15 to 20 years would decrease, not increase, tax revenues.

D. Any reductions in the cost recovery allowances for structures will dampen the economic recovery by retarding the growth of the real estate, the construction, and the other industries affected by the level of construction activity. The Coopers and Lybrand model shows that the adoption of ACRS did create increased investment in productive assets and that extending the recovery period from 15 to 20 years would reduce this investment below the level which would have occurred without ACRS.

E. The ACRS provisions of ERTA were adopted in 1981 in order to stimulate investment. The provision has been in effect only for a brief period and should be given a chance to work. The annual consideration of major tax provisions has a disruptive effect on investment, especially in long-term assets.

STATEMENT

I. Introduction

My name is Robert B. Aikens, I am President of Robert B. Aikens and Associates, Troy, Michigan, a real estate development and menagement firm. I also am a member of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony on behalf of the members of the International Council of Shopping Centers.

The ICSC is a business association of approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 23,300 shopping centers in the United States in 1982.

A. The shopping center industry

It is estimated that between 5.5 and 6.2 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable.

It is estimated that in 1982 shopping centers accounted for 43 percent of total U.S. retail sales. By the beginning of the next decade (1990), the shopping center share will likely range between 50 percent and 55 percent. In current dollar value, U.S. shopping center retail sales reached a level of $462.5 billion in 1982.

B. Economic benefits of shopping center development

The extent of the contribution of shopping center development to the nation's productivity is oftentimes not fully appreciated. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities—but not to the distribution of products to the ultimate consumer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since without adequate retail facilities there can be no expansion of the other links in the economic and production chain.

1. Employment.—Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a center provides employment to all sectors of the building trades. In addition, the ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial or office positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide the services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

2. Tax revenues.—The economic impact of shopping center development in local communities is clear. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues and personal property taxes on such things as office and retail equipment and inventories.

For example, a 1975 study published by ICSC included a twelve-year case history of the fiscal impact of a large shopping center in Oak Brook, Illinois. The Oakbrook Regional Shopping Center is as typical of the diverse facilities developed by ICSC members as any one shopping center can be. Nevertheless, the Oak Brook study demonstrates the substantial fiscal benefits to a community from shopping center development.

During the period from 1963 through 1973, the Oak Brook shopping center was the primary source of sales tax revenue for the Village of Oak Brook, Illinois. The shopping center's share of total municipal revenues ranged from a high of 91.3 percent in 1965 to 75.4 percent in 1973 (the last year for which the study developed data). Even after taking into account the very modest increase in municipal tax expenditures attributable to the shopping center's presence in Oak Brook (for example, increased police and fire protection and local road maintenance), the ICSC study found that in 1973 Oak Brook received net cash-flow benefits in excess of $1.2 million directly attributable to the shopping center. Without this net revenue source, the report concludes that Oak Brook would have experienced a deficit requiring either a decrease in expenditures or an increase in taxes. In fact, the local tax revenue generated by the shopping center allowed Oak Brook to maintain services without imposing a municipal property tax for a number of years.

C. Interdependence of the real estate industry.—The various sectors of the real estate industry are strongly interrelated. For example, shopping center development and rehabilitation follow very closely new housing starts and rehabilitation. The development and location of housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another. In a recent study conducted by the ICSC Research Department, the total square footage of annual U.S. shopping center construction starts (1970 to 1979) was correlated with annual U.S. housing starts (1969 to 1979). Results indicated that 95 percent of the variation in shopping center construction starts could be statistically "explained" by changes in the level of housing starts.

D. Small business development.—The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. It is well established that the vast majority of all new jobs are created by small businesses such as these.

Unfortunately, the small business nature of the industry makes it unusually susceptible to changes in economic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

It is important that the consequences of future tax policy changes on this important industry be carefully considered.

II. Proposals to change ACRS as it applies to structures

The Committee is holding these hearings on proposals to increase tax revenues, and there have been several proposals to raise revenues by reducing the capital cost recovery allowances for structures.

For example, the Congressional Budget Office (CBO) has listed the extension of the cost recovery period for structures from 15 to 20 years as a method of reducing the federal budget deficit.[1]

The International Council of Shopping Centers urges the Committee not to change the cost recovery period for structures to 20 years or to make any other changes in ACRS.

III. Comparison of the cost recovery period for structures prior to and under ACRS

A. *ERTA and TEFRA changes in depreciation/cost recovery allowances.*—In 1981 Congress enacted the Economic Recovery Tax Act of 1981 (ERTA). Among the changes in the tax law made by ERTA was the establishment of a new cost recovery system, the Accelerated Cost Recovery System (ACRS). The major differences between pre-ERTA law, under the Asset Depreciation Range (ADR) system, and ACRS are as follows:

(1) Cost recovery categories: ERTA reduced over 100 depreciation life categories to four cost recovery categories.

(2) Recovery periods: The recovery periods for equiment were reduced from various periods under the ADR system (ranging from three to 18 years) to five years for most property, and to three years for short-lived property (property with an ADR midpoint life of four years or less). The cost recovery period for structures was reduced from various periods determined under a facts and circumstances test to 15 years.[2]

(3) Methods of cost recovery: Most types of property were allowed to use more accelerated methods of cost recovery than under pre-ERTA law.

(4) Investment tax credit: No investment tax credit was provided for structures. However, the 10 percent investment tax credit for most equipment was continued, and a six percent credit was provided for short-lived property.

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA). TEFRA eliminated the additional acceleration for equipment previously scheduled to go into effect in 1985 and 1986, and made permanent the temporary ACRS benefits for equipment. TEFRA made no change in the cost recovery rules for structures.

B. Cost recovery for structures under pre-ERTA law and ACRS.—The benefits to real estate resulting from the reduced cost recovery periods of ACRS are not as large as sometimes perceived. One source of this misprecеption is the belief held by some that the recovery periods for structures dropped from 40 or 50 years to 15 years. Under pre-ERTA regulations, the depreciation period for retail buildings advocated by the Treasury and the IRS significantly exceeded the depreciable lives which shopping center industry studies indicate were generally claimed and upheld by the courts.

Under pre-ERTA law, the "component" parts of a building—such as the heating, air conditioning, electrical and plumbing systems, as well as the carpeting and light fixtures—could be separately depreciated at different rates. As a result, the actual weighted-average useful lives of virtually all buildings were substantially lower than those advocated by the Treasury.

In 1975 the Treasury Department issued a report on the depreciation practices of building owners. The report was based on data collected by the Treasury and on trade association data. The report found that depreciation lives were as low as 15 years for new shopping centers and 7 years for used shopping centers.[3]

A 1973 survey by Touche Ross & Co. of a representative sample group of 89 shopping centers owned by ICSC members established that the useful lives of shopping centers ranged from 22 to 29 years; [4]

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[1] "Reducing the Federal Deficit: Spending and Revenue Options," Congressional Budget Office, February 1983, pt. III, at 288–289.

[2] J. Gravelle, "*Effects of the 1981 Depreciation Revenues on the Taxation of Income From Business Capital,*" National Tax Journal vol. XXXV, No. 1 at 8.

[3] "Business Building Statistics, A Study of Physical and Economic Characteristics of the 1969 Stock of Non-Residential and Non-Farm Business Buildings and Depreciation Practices of Building Owners, 1971," Office of Industrial Economics, Department of the Treasury, August 1975, at 37–45.

[4] Touche Ross & Co., "Depreciable Lives of Shopping Centers, An Independent Study Prepared for the International Council of Shopping Centers," 1973.

The useful lives found in all of these studies were significantly lower than the 50 year life which IRS Revenue Procedure 62-21 required for retail buildings.

IV. Relationship of the cost recovery periods for structures and for assets prior to and under ACRS

The Congressional Research Service (CRS) has published a study of the relative impact of ACRS as established by ERTA on various assets used by the different sectors of the economy. The results of the study indicated that prior law favored investment in equipment assets over structures and that "under ACRS this trend is continued and strengthened." [5] The study found that under ERTA, the effective tax rates for all categories of structures were higher than those for all categories of equipment, and that some classes of equipment actually received a negative tax rate while all categories of structures had a positive tax rate. An excerpt from the CRS study is attached as Exhibit I.

The conclusions of the CRS study received further support from an analysis prepared by "Citizens for Tax Justice" published on February 19, 1982. The Citizens for Tax Justice analysis indicated that, under ERTA, assets other than structures enjoyed a negative tax rate as a result of ACRS. An excerpt from the study is attached as exhibit II.

In addition, the 1982 Economic Report of the President indicates that ACRS under ERTA favored investment in machinery, equipment and vehicles over that in industrial and commercial buildings.[6]

CRS also has published a study of the impact of ACRS as modified by TEFRA on various types of assets which concludes that, although the bias against structures was reduced by TEFRA, structures are still at a disadvantage compared to other assets.[7]

This same conclusion was reached in a book by the Director of Federal Tax Policy of Citizens for Tax Justice.[8]

According to Jane Gravelle of the Congressional Research Service, under pre-ERTA law, effective tax rates on new investments were 15 percent for equipment and 48 percent for structures (at a 6 percent inflation rate). Under TEFRA, the corresponding rates are 9 percent for equipment and 37 percent for structures.[9] (See Exhibit III for a comparison of effective tax rates by type of asset.)

According to Gravelle, the bias in favor of short-lived assets produces a disparity in effective tax rates by type of asset that results in a misallocation of capital. This misallocation of capital produces economic inefficiency, which she describes as "deadweight loss". CRS estimated that the "deadweight loss" resulting from the bias against structures amounted to between $2.7 to $3.3 billion annually under pre-ERTA law, and that the "deadweight loss" increased to from $3.5 to $3.8 billion under ERTA.[10]

Any decrease in the cost recovery allowances for investments in structures will add to the bias of effective tax rates against structures and will increase the "deadweight loss" to the economy.

This bias is demonstrated by a computer analysis made by Coopers and Lybrand for the National Realty Committee (NRC) using the CLEFS (Coopers & Lybrand Economic Forecasting Simulator) model. This model also is used by the Treasury Department under the acronym MAGPIE (Model for Analysis of Government Policy Impact on Efficiency).

This model has determined that ACRS provided substantially less of an incentive for investments in structures than for investments in other assets.

The CLEFS/NRC model shows that although the ACRS reduction of the cost recovery period for structures increased investment in commercial and residential rental structures, such increase was less than the increased investment in other assets which received greater incentives.

For example, according to CLEFS/NRC, in the first quarter of 1981 the capital stock of commercial and rental residential structures was 2.6 percent higher under

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[5] J. Gravelle, "Effects of the Accelerated Cost Recovery System by Asset type," CRS, August 1981, 6.

[6] Economic Report to the President, February 1982, at 124.

[7] J. Gravelle, "*Effective Tax Rates and Tax Charges in the 97th Congress,*" CRS, January 3, 1983, at 3,6.

[8] R. McIntyre, "*Inequity and Decline,*" 39-42, 103 (9183).

[9] J. Gravelle, "*Effective Corporate Tax Rates and Tax Changes in the 97th Congress,*" CRS, January 1983, at 6.

[10] J. Gravelle, "*Effects of the 1981 Depreciation Revenues on the Taxation of Income from Business Capital, National Tax Journal,*" vol. XXXV, at 17.

ACRS than it would have been under pre-ERTA law. During the same period the capital stock of equipment was 3.3 percent higher.

For the fourth quarter of 1982, these figures are 2.9 percent higher for commercial and rental residential structures and 3.5 percent higher for equipment under ACRS over the levels of capital stock which would have occurred under pre-ETRA law. (See Exhibit IV for CLEFS-NRC data comparing the capital stock of various asset types under ACRS and under pre-ERTA law.)

The relatively unfavorable treatment of investment in industrial, commercial and residential building under current ACRS rules can be tolerated by the economy, but such differences should not be expanded further by cutting back on ACRS deductions for structures.

V. Reasons for not changing the ARCS recovery periods for structures

A. The current cost recovery period for structures is reasonable compared to the cost recovery periods under prior law.—As discussed in Part III above, the establishment of 15 years as the recovery period for all structures under ERTA resulted in a lesser reduction of the recovery period for structures than would appear from comparing the Treasury guidelines with the 15 year recovery period under ACRS.

Part of the misperception of the size of the tax reduction under the ACRS 15 year recovery period for structures resulted from the failure to consider the net impact of tax law changes enacted in ERTA and TEFRA which reduced the tax benefits of investment in structures. Such changes include the elimination of component depreciation, the imposition of more restrictive construction period interest and tax deduction provisions, the passage of more restrictive investment interest limitations, the adoption of more restrictive recapture rules for those who elect accelerated cost recovery methods, and a larger alternate minimum tax assessment.

In addition, by adopting a uniform cost recovery period some investors, particularly in used structures, sacrificed the right to establish shorter useful lives under a facts and circumstances test. The application of the 15 year ACRS life also substantially benefits the Treasury through reduced administrative costs and more effective time utilization by revenue agents.

B. The Current cost recovery period for structures is reasonable compared to the benefits given other assets.—As discussed in Part IV above, ACRS already is biased against investments in structures. Lengthening the cost recovery period—and thereby reducing cost recovery allowances—for structures would increase this bias.

The impact of this proposal on investment in real estate has been projected by the CLEFS/NRC model by comparing the change in the capital stock of various types of assets. Using the capital stock of these assets under pre-ERTA law as a baseline, the CLEFS/NRC model determined the changes in the capital stock levels of these assets caused by ACRS and the changes in the capital stock levels which would be caused by extending the cost recovery period for structures from 15 to 20 years.

According to CLEFS/NRC, an increase in the cost recovery period for structures from the current 15 years to 20 years would substantially decrease investment in real estate. CLEFS projected a decline of 1.6 percent in the capital stock of commercial and rental residential structures below the level which would have occurred under pre-ACRS law in the first quarter of 1981 (compared with a 2.6 percent increase under ACRS). For the last quarter of 1982, a 20 year recovery period would produce a decrease of 1.2 percent in the capital stock of commercial and rental residential structures below the level which would have occurred under pre-ACRS law (compared to a 2.9 percent increase under ACRS).

Therefore, extending the cost recovery period for structures from 15 to 20 years would decrease investment in structures, not only below the levels existing under ACRS, but also below the levels which would have occurred under pre-ERTA law. (See Exhibit IV for CLEFS data comparing the capital stock of various asset types under ACRS with a 20 year cost recovery period for structures and under ACRS.)

C. The proposed increase in the cost recovery period for structures from 15 to 20 years would not increase tax revenues.—CBO has estimated that an extension of the cost recovery period for structures to 20 years would increase federal tax revenues by $400 million in fiscal year 1984 and $1.8 billion in fiscal year 1985.

These figures are illusory and inflated because they do not take into account revenue reductions caused by the resulting decreased economic activity in the construction industry and other industries affected by the level of construction activity.

The CLEFS/NRC model indicates that such a proposal would decrease, rather than increase, the flow of revenue to the Treasury. The CLEFS/NRC model determined that if this proposal were made effective in 1984, there would be a decrease in tax revenues of approximately $300 million in 1984, $500 million in 1985, $1 billion in 1986, and $1.5 billion in 1987.[11]

D. Economic impact.—Changing ACRS as it applies to real estate can be expected to have a negative impact on the economic recovery of the construction and related industries and of the economy as a whole.

(1) Permit ACRS to work: ACRS and the other provisions of the Economic Recovery Tax Act of 1981 were adopted in order to stimulate investment. The provisions have been in effect only for a comparatively brief period, and any extension of the ACRS recovery period for structures would significantly limit the incentives granted under ACRS and discourage desperately needed investment in industrial, commercial and residential buildings.

Although the economic recovery has begun, it is fragile and the need to increase saving and investment continues. The benefits to the economy of the increased investment which CLEFS/NRC shows has occurred under ACRS can be expected to increase with time. This is expecially true regarding the benefits from long-term investments such as real estate.

This investment incentive program has been in effect for only two years. Because of the long lead times involved in making many investments, including real estate investments, the impact of this policy is just beginning to be felt in the economy.

(2) Commercial buildings are productive assets: Structures are productive assets and increased investment in such assets promotes economic growth. Buildings incorporating technological advancements in insulation, environmental control, lighting, communications, security and other technologies can provide more effective and efficient work environments and increase energy efficiency.

Scientifically planned retail complexes, such as shopping centers promote efficient retail sales activities and efficient markets. The permit a consumer to meet his shopping needs at one location, and reduce the time and energy expended for transportation and the environmental impact of such travel. They also provide head-to-head competition under one roof, thus improving market efficiency. Morever, they accomplish this in a safe and pleasant and atmosphere suitable for the entire family.

(3) ACRS Is a Protection Against the Impact of Inflation: Although shopping centers may remain standing for many years, their useful lives as effective and efficient retail facilities are limited. It is important that the structures central to our service oriented economy are not allowed to deteriorate and become uncompetitive as have some facilities in industries such as steel and automobiles. As demonstrated by those industries, tax policies which fail to allow adequate capital consumption cost recovery allowances result in obsolete, unproductive, and uncompetitive industries. So long as cost recovery allowances are based on the original rather than the replacement cost of an asset, and so long as there is inflation—at any level—it is necessary to establish cost recovery periods for assets which permit taxation only upon income, and not upon capital.

In addition, long-term debt, which is so vital to investment in structures, continues to require higher interest rates than those required for shorter-term debt. This retards investment in structures and increases the bias against structures. Additional bias should not be introduced through the tax code.

Although the current rate of inflation is much lower than the extremely high levels reached in 1980, it is still quite high by historical standards and continues to result in a substantial difference between the original and the replacement costs on any long-lived asset.

The consumer price index increased 177 percent in the 15 year period prior to September 1982. Even at the present 3 percent inflation rate, the replacement cost of an asset would increase by 55 percent over 15 years. At a 6 percent inflation rate, the 15 year increase would be almost 140 percent.

The concern about inflation is not irrational since many economists expect that the rate of inflation will increase once the economic recovery gets underway.

(4) Impact of investment in real estate on construction and related industries: The health of the construction industry is directly dependent on the rate of investment in real estate. In addition, the viability of many other industries is largely dependent upon construction activity. For example, appliances, furniture, and other household goods and the construction materials industries, including steel, glass, lumber, concrete, construction equipment, and the real estate, building services and management industries also are directly dependent upon the rate of construction.

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[11] This data is included in the testimony of the National Realty Committee submitted to the committee.

The unemployment rate in the construction industry presently is 22.1 percent, more than double the national average. Creating a disincentive to construction activity would increase unemployment in the construction industry or, at the very least, would slow the decrease in the present high rate of unemployment in this industry.

(5) Avoid discouraging investment through unstable tax policy: Investments in new structures require extensive front-end time. Major revisions in the tax code provisions affecting business investments create uncertainty for potential investors and thereby reduce investment.

Also, any such changes in the tax law have an impact on existing investments. This is true even where the change is only prospectively applied because such a change will affect the resale value of the property.

The repeated consideration by the Congress of changes in tax law provisions has had a disruptive effect on the real estate industry and has had the effect of discouraging investment.

VI. Conclusion

A fifteen year recovery period and the acceleration methods provided under ACRS are reasonable methods for the depreciation of structures compared to the benefits given other assets and to the benefits for structures under prior law. Such treatment does not permit taxpayers to obtain tax treatment which is more favorable than immediate expensing of the costs associated with the construction of structures.

ACRS and the other provisions of the Economic Recovery Act of 1981 were adopted in order to stimulate investment. The provision has been in effect only for a brief period, and an extension of the ACRS recovery period for structures or a change in the method of calculating deductions would significantly limit the incentives granted under ACRS and discourage desperately needed investment in industrial, commercial and residential building.

Although no changes should be made in ACRS for any asset types, it is particularly inappropriate to consider stricter rules for structures since any changes would target that segment of the economy which benefits least from ACRS.

TABLE 1. Effective Tax/Subsidy Rates: Selected Assets, Prior Law and the New Accelerated Cost Recovery System (After Phase In)

Asset Type	Prior Law 6% Inflation	 12% Inflation	ACRS 6% Inflation	 12% Inflation
Cars	.15	.36	- .65	- .08
Trucks, Buses, and Trailers	.09	.42	- 1.08	- .09
Construction Equipment	.06	.34	- .60	- .07
General Industrial Equipment	.16	.36	- .40	- .05
Industrial Steam Equipment	.31	.44	- .27	- .04
Utility Power Plants	.27	.36	.15	.28
Industrial Buildings	.49	.53	.41	.48
Commercial Buildings	.48	.52	.36	.43
Apartment Buildings	.37	~~.39~~ .42	.31	.37
Apartment Buildings (low income)	.37	~~.39~~ .42	.30	.35

**The estimates of effective tax rates are based on equations (1) - (4) and assume the following:

	Value of d	Tax Life/ Prior Law Years	Credit: Prior Law Percent	ACRS Life Years	Investment Credit
Cars	.333	3	3 1/3	3	6
Trucks, Buses, and Trailers	.254	7	10	5	10
Construction Equipment	.172	7	10	5	10
General Industrial Equipment	.122	8.6	10	5	10
Industrial Steam Equipment	.0786	17.5	10	5	10
Utility Power Plants	.0316	22	0	15	10
Industrial Buildings	.0361	27	0	15	0
Commercial Buildings	.023	36	0	15	0
Apartment Buildings	.01	32	0	15	0

Source: The values of d are taken from "The Measurement of Economic Depreciation", by Charles Hulten and Frank Wykoff (The Urban Institute, December 1, 1980) except for apartment buildings where the rate is assumed at .01. Under prior law, depreciation calculations assume sum of years digits for equipment assets (including power plants) and apartment buildings; 150 percent declining balance for industrial and commercial buildings. ACRS depreciation is based on schedules in the legislation and 175 percent declining balance for structures, except for low income housing which is based on double declining balance.

TABLE II-4
EFFECTIVE CORPORATE TAX RATES ON THE INCOME FROM NEW INVESTMENTS UNDER THE REAGAN ACCELERATED COST RECOVERY SYSTEM

Type of Asset	Effective Corporate Tax Rate					
	1981	1982	1983	1984	1985	1986
Office, computing, & acct. machinery	-30%	-53%	-67%	-70%	-178%	-194%
Trucks, buses, and trailers	-28%	-48%	-60%	-63%	-150%	-163%
Autos	-20%	-37%	-48%	-52%	-83%	-97%
Aircraft	-20%	-33%	-40%	-42%	-84%	-89%
Construction machinery	-19%	-31%	-37%	-39%	-77%	-81%
Mining and oil field machinery	-18%	-29%	-35%	-37%	-72%	-76%
Service industry machinery	-18%	-29%	-35%	-37%	-72%	-76%
Tractors	-18%	-29%	-35%	-37%	-71%	-75%
Instruments	-17%	-27%	-32%	-33%	-64%	-67%
Other equipment	-17%	-27%	-32%	-33%	-64%	-67%
Metalworking machinery	-14%	-22%	-26%	-27%	-50%	-52%
General industrial equipment	-14%	-22%	-26%	-27%	-50%	-52%
Electrical machinery	-13%	-21%	-25%	-26%	-48%	-50%
Furniture and fixtures	-13%	-20%	-24%	-25%	-44%	-46%
Special industry machinery	-12%	-19%	-22%	-23%	-41%	-43%
Agricultural machinery	-11%	-18%	-21%	-22%	-39%	-41%
Fabricated metal products	-11%	-17%	-20%	-21%	-37%	-38%
Engines and turbines	-10%	-15%	-18%	-19%	-32%	-33%
Ships and boats	- 9%	-15%	-17%	-18%	-31%	-32%
Railroad equipment	- 9%	-13%	-16%	-16%	-28%	-29%
Mining exploration, shafts, & wells	- 8%	-12%	-14%	-15%	-25%	-25%
Residential buildings	+31%	+29%	+29%	+29%	+29%	+29%
Commercial buildings	+36%	+34%	+34%	+34%	+33%	+33%
Industrial buildings	+39%	+37%	+37%	+37%	+37%	+37%
WEIGHTED AVERAGES:	- 8%	-18%	-23%	-25%	-58%	-63%
MAXIMUM GAP BETWEEN RATES (MAXIMUM DISTORTION EFFECT):	69%	90%	104%	107%	215%	231%

NOTES: Negative numbers mean government subsidies for the investments, in the form of reduced taxes on other income or through tax leasing. Weighted averages are based on each asset category's share of 1978 corporate investment. (Assets covered represent 87% of 1978 corporate investment.)

SOURCES: Based on data, methodology, and sources from the Economic Report of the President, February 1982, page 123. (An apparent typographical error in the report, dealing with trucks, trailers and buses, has been corrected.)

Citizens for Tax Justice
February 19, 1982

CRS-6 EXHIBIT III

Table 2. Effective Tax Rates on New Investment

	Pre-1981 Law		Permanent ACRS		TEFRA	
	6% Inflation	9% Inflation	6% Inflation	9% Inflation	6% Inflation	9% Inflation
			By Broad Asset Type			
Equipment	15	26	-29	-10	9	20
Structures	42	44	30	34	33	36
Public Utility	27	32	14	21	25	30
Oil & Gas	9	10	9	10	9	10
Buildings	48	50	37	40	37	40
Total	33	38	15	22	25	31
			By Industry			
Agriculture	29	34	15	22	25	30
Mining	27	31	10	16	19	26
Oil Extraction	13	16	10	12	12	15
Construction	18	28	-18	-2	13	25
Manufacturing	37	42	18	25	29	33
Transportation	27	33	0	10	19	27
Communications	25	31	-2	8	16	25
Radio/TV Broadcasting	31	38	2	12	19	27
Electric, Gas	27	32	12	19	25	30
Trade	40	44	23	29	30	35
Services	39	43	22	27	29	34

Source: Congressional Research Service. Assumes a 4.6 percent real discount rate, based on a weighted average of the aftertax real interest rate and the return to equity.

TABLE 1. COMPARISON OF PRESENT LAW (ERTA AS AMENDED BY TEFRA) TO PRIOR LAW TRENDS

	1981	1982	1983	1984	1985	1986	1987
Differences from Prior Law (billions of $)							
Investment	18.8	23.1	28.3	35.0	41.9	48.3	55.6
Federal Tax Revenues	.6	1.2	1.6	2.8	3.8	5.1	6.9
Investment (1972 $)	10.4	12.0	13.6	15.7	17.8	19.4	20.9
Federal Tax Revenues (1972 $)	.4	.6	1.1	1.3	1.6	2.1	2.6
Capital Stock (1972 $)							
Equipment	18.8	19.6	23.1	26.0	27.3	30.3	33.8
Commercial and Rental Residential Structures	13.4	15.0	15.0	17.5	22.3	26.1	30.2
All Structures	-8.2	-.2	6.6	14.8	26.1	37.0	48.4
Percentage Differences from Prior Law							
Investment	4.12	4.61	5.25	5.12	5.55	5.88	6.01
Federal Tax Revenues	.07	.11	.17	.22	.29	.37	.46
Investment (1972 $)	4.13	4.63	5.28	5.15	5.57	5.88	5.98
Federal Tax Revenues (1972 $)	.11	.19	.34	.35	.44	.54	.64
Capital Stock (1972 $)							
Equipment	3.15	3.11	3.46	3.78	3.77	4.00	4.28
Commercial and Rental Residential Structures	2.84	3.09	2.96	3.30	4.03	4.55	5.02

Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

EXHIBIT IV A

EXHIBIT IV B

TABLE 2. COMPARISON OF PROPOSED LAW (20-YEAR LIFE FOR STRUCTURES) TO PRESENT LAW TRENDS

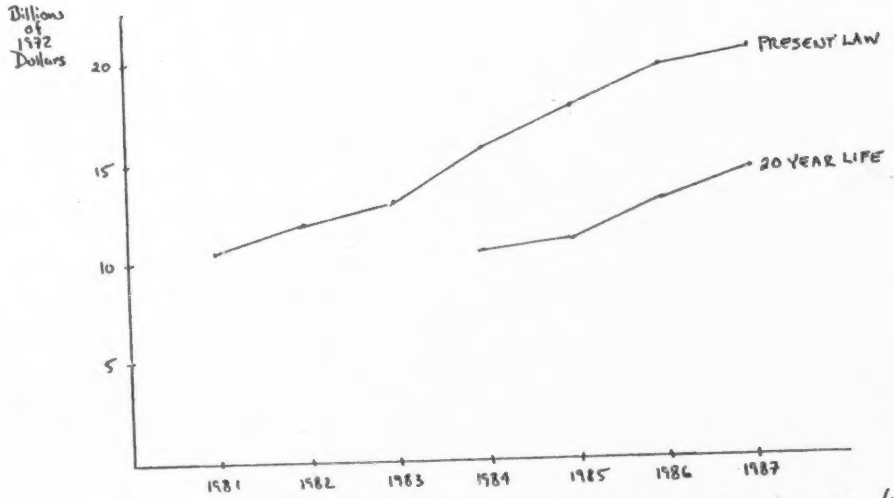
	1984	1985	1986	1987
Differences from Prior Law (billions of $)				
Investment	-10.6	-13.0	-15.6	-18.2
Federal Tax Revenues	-.3	-.5	-1.0	-1.5
Investment (1972 $)	-4.7	-5.5	-6.2	-6.9
Federal Tax Revenues (1972 $)	-.1	-.4	-.4	-.6
Capital Stock (1972 $)				
Equipment	5.9	5.6	5.3	4.8
Commercial and Rental Residential Structures	-20.4	-22.4	-24.5	-26.9
All Structures	-10.5	-14.4	-18.5	-23.0
Percentage Differences from Prior Law				
Investment	-1.48	-1.64	-1.79	-1.86
Federal Tax Revenues	-.06	-.05	-.07	-.10
Investment (1972 $)	-1.48	-1.64	-1.79	-1.85
Federal Tax Revenues (1972 $)	-.03	-.17	-.10	-.14
Capital Stock (1972 $)				
Equipment	.82	.75	.67	.58
Commercial and Rental Residential Structures	-3.63	-3.84	-4.01	-4.19

Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

EXHIBIT IV C

Chart 1

Gross Private Domestic Investment - Differences from Prior Law



Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

EXHIBIT IV D

Chart 4

Stock of Structures - Differences from Prior Law

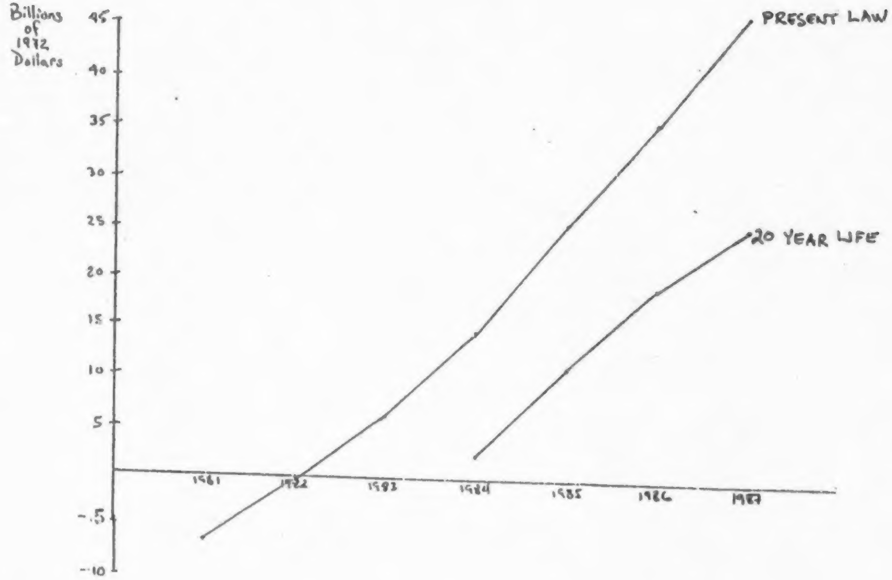


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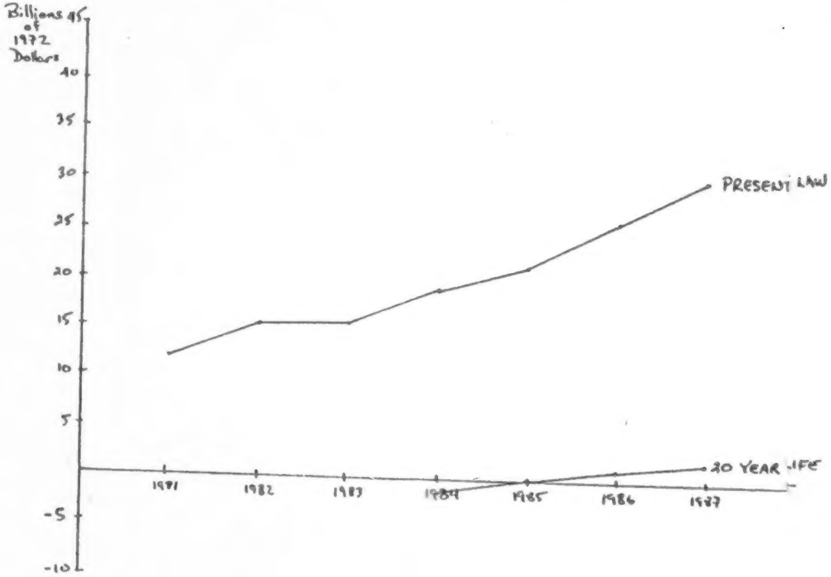
EXHIBIT IV E

Chart 5

Stock of Commercial and Rental Residential Structures - Differences from Prior Law



Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

STATEMENT OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

The International Union, UAW appreciates this opportunity to present our views to the Committee on the important issue of how to achieve revenue increases in the coming fiscal years.

The irresponsible and inequitable Reagan tax cut of 1981 is clearly at the root of the need for more revenues. Even after the beneficial effects of the 1982 tax legislation are tallied, half of the deficit expected in fiscal year 1984 can be traced to the 1981 Tax Act; and in later years, the proportion is much higher.

Indeed, the 1982 tax reforms were only a modest beginning toward restoring fairness to the federal tax laws and fiscal responsibility to the federal budget. We need to go far beyond those reforms in order to have a system which will raise sufficient revenues to fund the necessary functions of our federal government while distributing the tax burden in an equitable fashion.

It is regrettable that the first step down that road—the commendable effort by this Committee and the House to cap the July 1983 tax cut at $720—met with defeat in the Senate. As a result, the task before this Committee has become far harder. Similarly, repeal of dividend and interest withholding reversed an important step in the direction of tax justice and more adequate revenues.

Despite these unfortunate outcomes, the tax code still offers many constructive opportunities to increase revenues and improve fairness, precisely because the individuals and corporations that are not paying their fair share have reaped such lucrative tax windfalls in the last few years. In some cases, these unjustified windfalls have not yet occurred; changes in the taxation of both individuals and corporations should therefore start with, but not be confined to, the provisions enacted in 1981 that are not yet in effect. Those provisions should be repealed or—as proposed by Chairman Rostenkowski—frozen as of the end of this year. We discuss below the items at the very top of the UAW's tax reform agenda; this is not intended as an exhaustive list of the tax changes that should be enacted.

TAXATION OF INDIVIDUALS

Repeal indexation of tax brackets.—This action by itself would raise almost 45 percent of the revenues called for in the First Concurrent Resolution's reconciliation instructions. More importantly, however, repeal would remove from the books a provision that will straight-jacket the federal government regardless of the economic circumstances or social needs.

Indexation would also remove an important "automatic stabilizer": currently, when inflation accelerates, tax receipts gently rise, dampening price pressures. Indexation thus would result in even more of the inflation-fighting burden being placed on monetary policy; the experience of the 1979–82 period should have taught us to avoid that pitfall.

Moreover, a recent study done by the Congressional Research Service faults indexation on grounds of regressivity. CRS found that, had indexation been in effect during the 1971–81 decade, it would have decreased the progressivity of the tax system "for the vast majority of the taxpayers."

Repeal "savings incentives".—Beginning in 1985, 15 percent of interest received net of nonmortgage interest payments will be tax exempt up to $6,000. There is no justification for this windfall, which will favor the wealthy in yet another way.

In addition, the 1981 Act provides for several schemes supposedly enacted to increase savings which in reality only increase the unfairness of the tax code and squander federal resources.

Individual Retirement Accounts are an egregious example of these devices. It is estimated that proportionately more than twice as many employees earning $50,000 or more contributed to IRA's as did employees earning between $20,000 and $50,000, and that 10 times as many employees earning over $50,000 contributed to IRA's as did those earning between $15,000 and $20,000. The IRA amount can be deducted from earned income, so that not only are high-salary earners more likely to profit by using this new loophole; they also benefit from it proportionately more than the lower-income workers.

These new gimmicks have resulted in a substantial revenue loss to the Treasury: IRA's have accounted for an estimated $15 billion in lost revenues to the Treasury in 1982, nearly 10 times higher than the initially predicted loss. The revenue loss is expected to be almost as high for 1983.

No increase in personal saving has resulted, however, as recently acknowledged by CEA Chairman Martin Feldstein (Business Week, July 25, 1983). People have simply taken advantage of the higher effective yeild of IRAs and shifted existing savings into the new accounts.

At a minimum, there should be changes in the tax law to change the IRA treatment from a deduction to a credit. That would improve fairness at a lower cost to the Treasury.

Restore the estate tax.—In another blow to equity, the 1981 Revenue Act largely repealed the estate and gift tax. The rates and exemptions should be brought back to their former levels, which allowed an adequate $250,000 or half of the estate (whichever is greater) to be passed on to the surviving spouse tax free and provided generous credits for other heirs. At a minimum, the phase-out of the estate tax should be frozen at its 1983 level.

Reduce capital-gains preferences.—The current 60 percent exclusion of profits from the sale of stocks, bonds, and real estate and the total exemption of such gains when passed on to heirs flagrantly discriminates in favor of non-earned income. The exclusion should be cut back to the pre-1979 level of 50 percent, and a phasedown begun to totally esliminate this preference over a 5-year period.

In particular, capital-gains preferences for investing in gold, collectibles, and other nonproductive assets should be eliminated outright, as there is absolutely no economic justification for their preferential treatment.

TAXATION OF CORPORATIONS

In 1960, the corporate income tax financed nearly one-fourth of the federal budget, as against only 6 percent in 1984. If the corporate income tax were to bear the same share of the federal tax burden in 1984 as it did in 1980, receipts would almost double. Examples of specific ways to move in that direction include:

Eliminate tax breaks for the oil industry.—Oil depletion allowances and write-offs for intangible dwelling costs should be repealed. These loopholes serve no ligitimate economic function, and they favor both major oil companies and so-called independent producers, while continuing to provide generous shelter to the income of highly-paid individuals, such as physicians and other professionals.

Phase out tax preferences related to foreign operations.—Foreign tax credits allowed on a dollar-for-dollar basis against a multinational company's U.S. income encourage U.S. corporations to export jobs and to produce abroad. Foreign taxes should be treated just like other costs of doing business.

Multinational corporations are also allowed to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home. In many cases, that never occurs. Deferral should be ended.

The wasteful and inefficient DISC export tax subsidy, which allows corporations to spin off income and profits into export subsidiaries in order to defer, perhaps indefinitely, taxes on export profits, must be ended as well.

Disallow the "small business" rate for large corporations.—There is no reason why large corporations should only pay $26,750 on their first $100,000 of corporate profit instead of $46,000; this provision produces substantial foregone revenue to the Treasury.

Stop tax inducements for mergers and acquisitions.—Curbs should be placed on the ability of companies to take advantage of the unused tax breaks of firms they acquire; moreover, deductions of interest paid to finance unjustified corporate mergers and acquisitions should be disallowed.

Attach meaningful strings to tax credits.—The UAW has long advocated the rejection of the "scattergun" approach of providing investment incentives across the board; it is wasteful of federal monies, as in many cases it bestows a windfall on companies which would make the investment anyway. The alternative is to carefully target the relief—either directly or through the tax system—to those companies, industries, and regions which need it most and which agree to commit themselves to desirable actions in terms of employment levels, location of facilities, labor standards, etc. In the meantime, there should be curbs on the revenue drain related to the investment tax credit and accelerated depreciation.

End double-dipping on the investment tax credit.—Under the 1981 Tax Act, accelerated depreciation write-offs were allowed on the entire purchase price of new equipment, although 10 percent of that price was offset by the investment tax credit. In 1982, Congress disallowed accelerated depreciation deductions for half the value of the investment tax credit. That job should be finished by allowing depreciation deductions only after the full amount of the investment tax credit has been subtracted.

REVENUE-RAISING PROPOSALS OF THE REAGAN ADMINISTRATION

While the President's tax actions so far in his Administration have plunged the federal deficit deeper in the red than ever before, they have failed miserably in their avowed mission of promoting investment and savings. Fixed investment by business has declined significantly since early 1981; and the savings rate has touched its lowest point in 24 years. The Administration asserted that one of the major benefits of its tax-cutting program would be to channel money into more productive areas by reducing the incentive to use shelters. Yet, as widely reported in the press recently, tax shelters are clearly on the rise; according to one estimate, the increase from 1982 to 1983 may be as high as 50 percent, or $4 billion.

Thus, a thinly veiled objective of Reagan's tax agenda has been accomplished: the distribution of income has been drastically skewed even further toward the rich, as evidenced by the flourishing sales of Rolls Royces, Mercedes, and other merchandise only the rich can afford.

In spite of this, the Administration is back for more. We urge this Committee to firmly reject Reagan's 1984 tax program. Rather than curbing the proliferation of tax breaks, the Administration is adocating new ones, including "enterprise zones", tuition tax credits, and education savings tax breaks tilted toward the better off.

The UAW is particularly concerned about the sole so-called reform item in the package, i.e., the proposal to tax a portion of employer-paid health insurance premiums. This proposal is based on the mistaken notion that health care costs are so high because workers have too much health insurance coverage. The proposed tax would not achieve anything in the way of restraining inflation in the costs of health services. Instead, it would increase taxes on wage-earners already struggling under the lingering economic distress of Reaganomics.

The Administration tax proposals also include a "contingency" tax to take effect on October 1, 1985 if the federal budget deficit exceeds certain levels and if the economy is growing below a certain rate, among other conditions. The contingency tax would consist of an income-tax surcharge and an excise tax on oil.

We see no merit whatsoever in this proposal. We reiterate that tax increases must be designed not only with the objective of raising revenues, but to improve the progressivity of the tax code as well. Recent reports that the Administration has decided to put the contingency tax proposal on the back burner are thus welcome news.

PROGRESSIVE TAXATION OF INCOME MUST BE RETAINED

The erosion of the tax system, as both a federal revenue raiser and a factor in the progressive redistribution of income, have caused a great deal of concern. This has been fertile ground for several proposals to change the system drastically, and in ways which would ironically accentuate the victimization of the lower and middle income groups. Among these proposals, the flat rate tax, an individual tax based on consumption and a VAT-type tax have generated the most attention.

The UAW is absolutely opposed to a flat-rate tax. Under the guise of simplification, a flat rate would shift the burden of taxation further away from high-income individuals. That is also the likely outcome of moving to consumption taxes—whether they totally replace income taxes or complement them in the form of a national sales tax—which in turn is the reason we oppose such changes. The UAW firmly believes that the principle of ability to pay should continue to guide our tax laws. Sixty years of experience with income taxes should not be abandoned. Contrary to the "trickle-down" notions of the supply-siders, we should redouble our efforts to regain and improve on the progressivity that has been chiseled away from the American tax code.

STATEMENT OF D. MICHAEL MURRAY, LEGISLATIVE COUNSEL, IRON ORE LESSORS ASSOCIATION, INC.

In 1963, after extensive debates in both the Senate Finance Committee and in the Committee on Ways and Means, Congress enacted legislation (U.S. Code 631(c)) that treated the sale of iron ore as that of a capital asset, and therefore taxable as a capital gain rather than as regular earned income.

Fair taxation of the proceeds given to a landowner from the sale of iron ore has been a problem due to the peculiar nature of the investment. Once iron ore lands are purchased, they often lay undeveloped, sometimes for decades before an operator begins mining, and only then do they show a return on investment. Historically, landowners have been taxed at the maximum earned income rate due to the scale of such activities. This has been recognized as inequitable as applied to this category of landowner. It is also poor public policy to hinder the development of American iron ore reserves and directly contribute to the increased costs of domestic steel. The legitimacy of this problem was finally acknowledged by Congress and remedied.

Not only did the capital gains treatment contribute to the solutions of the problems facing the iron ore and steel industries, it is the proper theoretical treatment for the sale. Iron ore property is purchased as an investment, just as one would buy stock or any other capital asset. The only difference between iron ore and most other capital assets, and one that weighs more in favor of the present tax classification, is that it is only disposed of gradually over an extremely long period of time. In some cases, the lands may not be touched for over half of a century.

This proper sales classification has unquestionably stimulated and produced, indirectly, considerably more revenue than the comparatively small amount of tax directly attributed to disposal contracts. The Joint Committee on Taxation estimates the Federal Tax Expenditure for the iron ore industry to be $10 million dollars in 1983 with no increase for the period through 1987.

For the following reasons, we consider any change in th present tax classification most inequitable and ill-advised and urge that the capital gains treatment be retained for iron ore classifications.

DAMAGE TO U.S. STEEL COMPANIES

Increased costs related to domestic iron ore will also worsen the competitive position of the U.S. steel industry. Many U.S. Steel producers have invested millions of dollars to develop iron ore lands. The investment includes the actual mines, pelletizing plants, railroads, dock facilities, and often even container fleets. Because of the size of these investments these companies literally cannot afford not to use them. To shift to lower cost imported ore would be the equivalent of writing off billions of dollars of investment (not to mention thousands of jobs). Therefore, these steel companies must use this ore and any increase in cost in producing it must either be reflected in higher steel prices or lowered profits. This is hardly what the industry needs at this time.

THE INFLATION PENALTY

To tax royalties paid upon the removal of iron ore from the land as regular income ignores the effect of inflation over the very long holding period for iron ore lands. Iron ore lands are not the type of assets that are constantly being turned over by speculators seeking to turn regular income into capital gains.

An investment in iron ore lands may not see any income for decades, and then the return will be spaced over decades more. In fact, several members of the Iron Ore Lessors have been developing the same lands for almost a century. To tax this income at regular earned income rates would be most unfair to the holders of this type of asset.

HIGHER DOMESTIC IRON ORE PRICES

More imported foreign ore

Should the earned income tax rate be imposed on the sale of iron ore, the owners would be forced to raise their prices when leases are renegotiated, to compensate for the increased tax. Such a price increase would damage an already weakened domestic iron ore industry and encourage increased imports of foreign ore. It should be noted that most of these imports come from nations with government controlled mining companies. Besides not paying comparable wages or employing the environmental safeguards that U.S. producers employ, these nations are chiefly interested in iron ore as a source of foreign currency. Therefore, they will consistently undercut U.S. prices.

If the domestic price of iron ore cannot rise enough to meet some of the increased costs of the tax increase, an option open to some owners is to withdraw all or most ore from the market and await higher prices. This could trigger massive unemployment in the iron fields.

Currently the iron ore industry is operating at roughly 31 percent of its aggregate national capacity, a rate which approximates that of the Great Depression. The unemployment situation in the iron ore industry is at a crisis stage. Unemployment in the industry is running at about 11,300; thus, it is an industry with over two-thirds of its workforce laid off.

It is clearly evident that the economic condition of the United States steel industry has reached a crisis stage. The outlook for improvement is quite dim due to increased foreign competition. Repeal of or alteration of the capital gains tax on iron ore would be very detrimental to an industry that is trying to remain solvent. This critical industry should not be penalized by the tax code at a time when its very survival is so questionable.

I believe that without a tax policy that encourages the proper management of our iron ore resources, the needs of our steel industries will not be met. The current economic situation of this industry clearly demonstrates the continued need for iron ore capital gains treatment.

STATEMENT OF T. W. BURGE, VICE PRESIDENT, MACHINERY DEALERS NATIONAL ASSOCIATION

I am T. W. Burge, Vice President of Machinery Dealers National Association (MDNA) and President of The Machine Tool Exchange, Inc. which is located in Santa Fe Springs, California. I am submitting this statement on behalf of the 500 MDNA member firms. We are small businesses which account for over 70 percent of the used machine tools sold in the United States. Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers, MDNA members are in the unique position to articulate the economic problems of the small business community. Our statement concentrates on our concern about the impact which Chairman Rostenkowski's freeze proposal will have on the investment tax credit for used machinery and equipment. We believe our concern is shared by all small businesses.

Under present law, there is a $125,000 limitation on the amounts of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment. This ceiling will increase to $150,000 in 1985. Similarly, the same carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment who may not carryforward or carryback tax credits on investment over the limitation amount.

Since the original $50,000 ceiling was established in 1962, the cost of basic, unsophisticated used equipment has generally increased by over 500 percent. It would cost over $600,000 to start a small machine shop which would employ ten people. If a large company which could afford to buy new equipment purchased $600,000 of equipment, it would receive an investment tax credit of $60,000 (10 percent of $600,000). If a small firm bought $600,000 of used equipment, it would receive an investment tax credit of $12,500 (10 percent of $125,000). In addition, purchasers of new equipment can carryback three years and forward fifteen years that part of the investment tax credit on the $600,000 purchase which cannot be used in the year of purchase. The small business which purchases used equipment can carryback and carryforward only the $12,500 which is allowed as a result of the limitation. The $475,000 in excess of the limit would receive no investment tax credit in any year. This example clearly illustrates the discriminatory impact on small business of this limitation.

Furthermore, an established manufacturer has hardly begun to retool before he realizes that the $125,000 ceiling offers him very little assistance at all. The original arbitrary and inadequate limit of $50,000 was merely a token gesture to small business and in light of inflation, doubling the limit to $100,000 thirteen years later and to $125,000 nineteen years later, has perpetuated the injustice.

This discriminatory tax treatment impacts directly and primarily upon small businesses which are already hindered by their inability to externally or internally generate the capital necessary to buy equipment. Capital stock formation among small business (which may be the nation's best source of economic growth) has been impeded by high interest rates, restricted availability of credit, the government's regulatory burdens, the prolonged recession, and tax laws which discriminate against small business. Since small business cannot generally afford or justify new machinery, it requires quick passage of tax incentives which will enable it to buy the used equipment it needs for start-ups or to boost productivity and expand the capacity of its current business.

The Joint Economic Committee and the White House Conference on Small Business both have recognized the disparity between large and small businesses as they are affected by inflation and current tax policy. Both have called for tax measures targeted to small business that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion.

The current disparity between the investment tax credit available to new and used equipment is in effect a Congressionally mandated discrimination against small business which directly dilutes the ability of small business to compete with large firms and survive. This disparity also allows new foreign machinery a competitive edge through the investment tax credit advantage over equally efficient and price competitive used domestic machinery. We assume this was not the original intent of the $50,000, $100,000, and $125,000 ceilings.

In the 97th Congress, both the Senate and the House Small Business Committees identified the tax credit for used equipment as one of the top priorities in their capital formation and tax recommendations. When introducing his proposal to raise the current arbitrary limitation (S. 360), Senate Small Business Committee Chairman, Lowell Weicker, stated that "the substantial small business dependence on used equipment, particularly in this high technology environment, suggests that as a matter of simple equity for our Nation's small businesses the existing ceiling on used investment should be increased, *if not removed entirely.*" (Emphasis added) Senator Weicker's bill would have raised the ceiling from $100,000 to $250,000. He also urged the Finance Committee to phase in an elevation of the ceiling to reach $500,000 by 1985. Senator Weicker concluded that "elementary justice" and the "improved productivity of our economy" required this basic change.

The importance of this issue is further evidenced by the fact that eight legislative proposals in the House and two in the Senate had been introduced in the 97th Congress, including Senator Weicker's bill. Senator Bentsen introduced S. 1140 which was cosponsored by Senators Danforth, Baucus, Mitchell, and Chafee. That bill would have raised the limitation to $250,000 and allow a carryback and carryforward of the cost of used equipment if it exceeds $300,000 for any taxable year. Senator Bentsen stated that he believed "that an increase in the regular investment tax credit for used equipment is necessary to assure that the small businesses participate in the general upgrading of productive facilities which this proposal is intended to stimulate. . . . Finally, by allowing a carryover of any unused tax credit, we insure that businesses make the necessary investment this year without being deterred from making such investments due to the limitation on the amount of property qualifying for the investment tax credit." Senator Bentsen continues to be concerned about this issue and may introduce a small business tax bill that will remove the limitation entirely.

In the House, Congressman Bill Freznel and Congressman Kent Hance introduced H.R. 1377 and H.R. 3759, respectively, both of which eliminated the limitation entirely. Congressman Tom Downey Introduced H.R. 3644 which would have raised the limitation to $300,000 and allowed a carryback/carryforward of the cost of used equipment in excess of that limitation for any taxable year. Congressmen Jimmy Quillan, Dan Marriott, Marty Russo, and Cecil Heftel introduced bills which raise the limitation to $500,000, $300,000, and $200,000 respectively.

We appreciate the efforts of these Senators and Congressmen in the 97th Congress to help on this issue. We are concerned that the mere raising of the limitation perpetuates the discrimination which is inherent in the current provisions of the tax code. The carryback three years and the carryforward seven years of the amount in excess of the limitation which was included in a number of these bills would have helped ameliorate this discrimination against small businesses.

In 1975 the Senate Finance Committee reported out and the Senate passed a tax bill which would have eliminated the limitation entirely. In 1981, the Senate Finance Committee reported out a tax bill which eliminated the limitation and required a recapture of the tax credit computed upon the resale value of the used equipment. On the Senate floor this provision was dropped from the bill and Senators Weicker and Durenberger succeeded in the passage of an amendment which raised the ceiling to $125,000 in 1982 and $150,000 in 1985.

In 1981 the Ways and Means Committee reported out a bill which would have allowed expensing of all capital investments. This approach was an even-handed way of stimulating both small and big business to invest in upgrading their facilities. Unfortunately, the Senate version prevailed and the discrimination against small business was perpetuated.

Our proposal for small business relief from the discriminatory limitation on the investment tax credit for used equipment and machinery was supported in the 97th Congress by the Small Business Legislative Council (see Appendix A), the National Federation of Independent Businesses, the National Association of Wholesaler Distributors, the National Small Business Association, as well as many other small business trade associations. In a poll conducted by the House Small Business Committee, this issue ranked in the top three of all small business tax priorities.

We commend the Ways and Means Committee for the approach it took in 1981 and urge that it give priority to passage of tax legislation which will eliminate the limitation during this Congress. The benefits to our economy which can be derived from removal of the limitation are: more competitive small businesses, stimulation of capital investment, development of creative and innovative products and processes, starting new businesses, helping small business maintain its market share and survive, expansion of capacity and productivity, increased employment, improved balance of payments, increased demand for new domestic machine tools, reduction in inflation, generation of more tax revenues, and equal opportunity for growth of all businesses.

Unfortunately, Chairman Rostenkowksi's freeze proposal goes in the wrong direction because it will have an inordinate impact upon small businesses particularly those in the industrial sector which have been hardest hit by the recession. The machine tool industry and especially the used machine tool sector has been devastated by the recession and has not yet felt any impact from the economic recovery which is currently underway. The small manufacturers which purchase used equipment are currently unable to make the capital investments necessary to make themselves more competitive and productive. At a minimum they need the increase from $125,000 to $150,000 in the ceiling on the amounts of used equipment eligible for the investment tax credit which is scheduled to be phased in 1985. The freeze proposal would preclude that nominal $25,000 increase in the limitation. In order to allow the small manufacturers to participate in the recovery, we urge the Committee not only reject the freeze proposal as it applies to the limitation on the investment tax credit for used machinery and equipment, but we urge that it take the necessary step of eliminating the ceiling entirely. A viable alternative would be for the Committee to consider its 1981 expensing proposal which eliminates the discriminatory treatment of small and big business and avoids the complications and controversies which have developed in regard to the depreciation and investment tax credit areas of our Internal Revenue Code. Either of these two approaches will allow small businesses to participate aggressively in the recovery.

This Committee knows that the small business sector offers the greatest potential for increasing employment. The purchase of used machinery not only increases productivity but also directly creates new jobs. As noted earlier, small businesses increase productivity primarily with used equipment. Small business is also responsible for 55 percent of all employment in the private sector. A 1979 study by the Massachusetts Institute of Technology, The Job Generation Process, shows that job creation and replacement is achieved through the small business sector. The data shows that the largest number of new jobs emanated from very small firms with twenty employees or less. For the period of 1969 to 1976, the small firms generated 66 percent of all new jobs in the United States. Businesses with five hundred or more employees, by contrast, created only 13 percent of the new jobs. The firms of intermediate size accounted for the remaining 21 percent.

In its 1980 report, the Joint Economic Committee found that: "(1) Given the historical tendency of the small business to employ relatively lower ratio of capital to labor than large business, each additional dollar invested in small business is likely to generate more jobs than if it were invested in large business. A policy of small business growth would have its greatest effect in decaying cities where structurally the unemployed have the most difficulty finding job opportunities. Traditionally, young people in this country use jobs in small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers." (p. 72)

It is my experience that there is a direct relation between increased purchases of used machinery and increased employment. Furthermore, the small business owner is the last to lay off his employees. He has a strong social conscience which is reflected in his dedication to his employees and his community. With targeted tax incentives like the elimination of the limitation on used machinery and equipment, small manufacturers can not only participate in the economic recovery, but they will generate the jobs necessary to lower the very high unemployment our country is currently suffering.

We believe that small business is crucial to the survival of a free enterprise system, a sustained economic recovery, and increased employment. Small business is an effective force even in heavily concentrated markets, but its position is fraught with difficulties. The tax laws should not further handicap small businesses by giving tax breaks to industrial giants and denying such incentives to small businesses. We urge rejection of the freeze proposal and favor passage of legislation that will eliminate the limitation on the investment tax credit available to purchasers of used machinery and equipment not only for the major assistance it will give small business in its capital formation efforts but also because of the symbolic importance of the Congress going on record against discriminatory tax treatment of small business.

MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., July 19, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted in connection with the Committee hearings scheduled for July 20 to consider increasing tax revenues and the timing of any revenue increases. The Mortgage Bankers Association of America (MBA) respectfully requests that the letter be included in the hearing record.

MBA is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

We appreciate the opportunity to express our views on those provisions in the Federal income tax law that encourage the ownership and development of real estate. As has been demonstrated in the past few years, high inflation rates discourage investment in real estate, which is a relatively long term asset, compared with other types of property, such as equipment. The carefully developed real estate related provisions of the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) responded to recent high inflation by providing desirable tax treatment to restore the balance of incentives for long term real estate investments. MBA believes that the inflationary pressures of the past decade are still present and that the real estate related tax provisions enacted and ratified by Congress in 1981 and 1982 are still appropriate and needed. Therefore, MBA urges this Committee to recommend that no changes be made, at the present time, to those provisions in the Federal income tax law that encourage the ownership and development of real estate.

Inflationary pressures

MBA is deeply concerned and disappointed that the President's budget for 1984 has failed to produce substantial cuts in the Federal deficit. The huge and unacceptable deficits projected for 1984, 1985, and 1986 mean the Government will continue to absorb increasing amounts of credit that the private sector sorely needs to ensure economic recovery.

The devastating effects of the deficits cannot be overemphasized. Protracted deficits will severely inhibit, if not prevent, the economic recovery; threaten to rekindle rapid inflation; and aggravate the fears of consumers, lenders, and investors, who understand too well that the existence of deficits over long periods means that obtaining affordable credit will become more difficult, if not outright impossible.

MBA has called upon Congress to attack seriously the problem of too rapid growth in the Nation's defense expenditures and in entitlement programs, including Social Security. Only after everything has been done to curtail the growth in spending in these areas, should tax increases be considered. By substantially reducing the Federal deficit over the next several years, Congress can do much to restore confidence that a sustainable, noninflationary recovery in the private sector of the American economy is likely.

The ideal tax system

An economically sound tax system should be based on two principles. First, such a system should be neutral, that is, one where the investment decisions made are the same ones that would occur had there been no tax at all. Under a neutral tax system, the pre-tax return would be independent of the durability of the investment, and the tax would not alter the mix of investments. Second, a tax system should be equal, that is, one where the same effective tax rates are levied on all types of assets.

A perfectly neutral and equal tax is not likely to exist within the U.S. Tax Code. Most tax changes over the last thirty years have been undertaken to achieve some policy objectives or to help some specific group. A primary example is the mortgage interest tax deduction for homeowners. It is not to be expected that the Congress can or even should pass a perfectly neutral or equal tax law. However, reasonable standards of tax neutrality are a significant measure of a successful tax law.

Effects of inflation on real estate investment

A weakened dollar and a reduced rate of productivity increases in the U.S. economy, during the 1970s, focused public attention to the problem of capital formation in the United States. As a result, the staff of the Federal Reserve Board (FRB) completed a study of the problem in 1981. The study reported that, since 1962, the composition of investment had shifted away from investment in structures toward investment in shorter-lived assets, such as equipment. This trend toward shorter-term investing was compounded by lower rates of capital formation in the United States, relative to other industrialized countries. The study also found inefficiencies in the allocation of scarce capital stock in the U.S. economy. In addition, the FRB research confirmed that the tax system in effect in 1980 and 1981 favored shorter-term over longer-term investments. These factors resulted in lower rates of capital formation than would otherwise be the case. Moreover, inflation and the tax laws did not have the same effects on all types of capital assets. Inflation acted as a tax by reducing the value of depreciation deductions and by causing taxes to be levied against nominal rather than real (inflation-adjusted) capital gains.

PROVISIONS RELATING TO INCOME-PRODUCING PROPERTY

The basic change: The accelerated cost recovery system (ACRS)

The conclusion of the 1981 FRB study of capital formation was that the existing capital stock was seriously misallocated. The report suggested a variety of ways in which tax law could be rewritten so as to direct the flow of investment more efficiently. The most prominent among these suggestions was the Accelerate Cost Recovery System (ACRS). Acceleration of the rate at which capital can be depreciated increases the discounted present value of the depreciation deductions to recognize more accurately the depreciation of capital as a current cost of doing business. Accelerated depreciation mitigates the overall bias of the tax system against business capital. Additionally, the ACRS is easier to administer than the previous system of assigning a "useful economic life" to hundreds of different kinds of equipment, vehicles, and structures.

The ACRS made dramatic changes in the way assets may be depreciated for tax purposes. These changes greatly simplified and streamlined the depreciation process. The most basic change was the replacement of the useful economic life concept. In its place, three basic time periods were set up, one for each category of asset. Thus autos and light trucks could be depreciated over three years, equipment over five years, and structures over fifteen years. Congress incorporated the ACRS in the Economic Recovery Tax Act of 1981.

The question of whether the new change meets its objectives, and whether, in doing so, it is reasonably neutral and equal is not yet subject to an answer. A full evaluation of the economic effects of ACRS must wait until we have more data on investment flows and allocation. However, in discussing whether ACRS should be changed or allowed to remain as it is, some general comments can be made.

Expected tax treatment is of primary importance in estimating the profit or loss from a real estate investment, and projects planned since the implementation of ACRS have relied on these new depreciation rules. In contemplating the public policy implications of changing ACRS, it must be remembered that the feasibility of new projects and the market value of existing property will be affected, either favorably or unfavorably, by any major changes in tax treatment. Such changes create windfall gains or losses for real estate investors and owners who are providing rental housing, office, retail and wholesale space, warehouses, and other facilities needed by a growing and mobile economy. To the extent that such changes are unfavorable to real estate, they prevent some new project from being built, and they inflict losses on project owners who already have committed their funds. The losses caused by such changes in tax treatment must be passed along to renters and consumers, or are suffered by property owners, depending on market conditions.

Because of the one- to three-year planning and construction period required for most commercial real estate projects, plans must be based on assumptions about future market conditions, costs, revenues, and tax treatment. Frequent changes in tax treatment add to the uncertainty inherent in planning a real estate project, imposing a cost that must ultimately be paid through higher rents or reduced equity. Although tax treatment may need to be changed to reflect public policy decisions, it should be recognized that changes impose costs on the economy, forcing a reallocation of resources and prices. Too frequent changes can disrupt the market by introducing an additional element of uncertainty and risk, adding to costs.

There has been some discussion that the proper period for depreciation of real estate structures under ACRS should be 20 years rather than the current 15 years. The difference between a 20-year depreciation period and a 15-year depreciation period will make some proposed construction projects uneconomical, of course, but the very changing of the depreciation laws, so soon after they were established, will have a widespread deleterious effect that cannot be measured by analyzing a hypothetical real estate project using 20 and 15 year alternatives. Unless investors can be reasonably certain that Congress recognizes the importance of a stable investment environment and does not intend to tinker frequently with the tax code as it affects real estate, the desirable and necessary development of real estate structures will not be financed.

Industrial revenue bonds

Although mortgage bankers participate in financing real estate structures using industrial revenue bonds, MBA does not support the Federal income tax exemption for financing private industrial income-producing facilities, except where such financing is used to meet city, state, or Federal environmental requirements, or is used to finance federally or state-assisted multifamily housing that is targeted toward meeting the needs of the disadvantaged, specifically low income families, the elderly, and the handicapped.

Deduction of construction period interest and taxes

Under current law, interest and taxes paid during the time of construction must be amortized over ten years rather than allowed to be deducted on a current year basis. This provision works a hardship on investors, particularly during times of extremely high interest rates. The construction period expenses for interest and taxes are a significant element in the cost of a real estate project. The industry guideline is that construction period interest paid will total roughly the interest rate paid times one half the cost of the building. Thus, for example, a $20 million structure, taking two years to construct, with 14 percent construction financing will incur a construction period interest expense of roughly $1.4 million. Requiring this expense to be capitalized and recovered over ten years, in inflationary times, means that investors not only must wait for the tax relief, but also will receive it in dollars that have less purchasing power than those invested during the construction period. MBA urges the Committee to recommend that the deduction of construction period interest and taxes be allowed as an expense in the year they are incurred.

Deduction of preopening expenses

Owners of commercial facilities, and to a lesser extent, multifamily projects incur expenses prior to the time they are operating as a business. The Internal Revenue Service, by regulation, has required these expenses to be capitalized rather than deducted as current expenses. Start-up expenses are not acquisition or construction expenditures of the type that are traditionally amortized. They are necessary and ordinary business expenses, even though they are incurred prior to the time the business is a formally operating entity. MBA urges the Committee to recommend that pre-opening business expenses be specifically defined as currently deductible trade or business expenses.

Interest on investment indebtedness

The limitation on deduction of interest on investment indebtedness by individuals and partnerships in the current law can impede the development of real estate projects. Successful real estate developments are often highly leveraged. During times of high inflation, with interest rates at record levels, debt service may exceed income by a wide margin for the initial years of operation. The cost of the money used to finance the acquisition of real estate should be recognized as a necessary and ordinary business expense. MBA urges the Committee to recommend removal of the limit on the deduction of interest investment expense by individuals and partnerships.

Special types of structures

Multifamily: There are many reasons why investment in the production of multifamily housing is increasingly less attractive. However, the reasons can be summed up by saying that the rate of return is limited because rent levels are not adequate in the face of prohibitively expensive debt service and constantly increasing operating expenses. As a result, rental housing is rarely a profitable venture for investors. Without compensating factors, this state of affairs will continue and we will find ourselves in the midst of an increasingly severe housing shortage, particularly for low- and moderate-income families. In recognition of the special needs for encouragement of investment in these structures, current law provides that multifamily buildings may be depreciated at a rate in excess of straight-line, with more favorable recapture rules than other income property. Also, a special five year amortization period is allowed for the rehabilitation of housing for low income families. MBA urges that the Committee make no recommendations to weaken these provisions.

Historic properties: In order to encourage the preservation of historic properties, certain special deductions and credits are allowed for the preservation and rehabilitation of structures deemed to be historic. Older cities, especially, can and do benefit from the tax law treatment available to owners and developers to recycle older, historic properties. MBA urges that the Committee recommend that historic properties continue to receive special favorable treatment under the tax law.

Miscellaneous

There are several other provisions in the tax laws that encourage investment in real estate and that MBA urges the Committee to recommend be retained. Profits in real estate should continue to be subject to capital gains treatment, and state and local taxes, including property taxes, should be recognized as ordinary expenses, in the same manner as these items are treated for other types of investments.

PROVISIONS RELATING TO HOMEOWNERSHIP

Revenue bonds for housing

Another major recent development involving Federal tax laws that affect real estate ownership and development is the threatened termination of the ability of states and municipalities to issue revenue bonds for housing.

Mortgage bankers have participated extensively in homeownership programs financed with the proceeds of tax-exempt revenue bonds. When properly administered and properly targeted, revenue bond programs can provide homebuyers with needed financing and mortgage lenders with a new source of business opportunities, without infringing upon markets that can be served without government subsidy.

MBA opposed the use of municipal tax-exempt revenue bonds to fund homeownership when such bonds mushroomed in 1978. The rapid proliferation of these bonds for home mortgages allowed the substitution of public funds for private funds in the marketplace. In addition, they were an inefficient way to delivery governmental help even to those in our society who could not be served adequately by private lenders. Others, too, saw the danger of the apparently limitless use of home mortgage revenue bonds, and in the Mortgage Subsidy Bond Tax Act of 1980, (Subtitle A of the Revenue Adjustments Act of 1980, Title XI of the Omnibus Reconciliation Act of 1980, PL 96-499), Congress provided that the tax-free status of such bonds would expire at the end of 1983.

The Mortgage Subsidy Bond Tax Act of 1980 not only established an expiration date in the future, it imposed other restrictions to be effective until that expiration date. A statewide ceiling was set on the volume of bond issuances; a one percent arbitrage limit was imposed; only first-time homebuyers could be financed; and the maximum purchase price that could be paid using tax-exempt financing was set at 90 percent of average for the area (110 percent in areas of special need). The practical result of these interim restrictions was to prevent the issuance of tax-exempt revenue bonds for housing almost immediately, long before the established December 31, 1983 expiration date.

Recognizing that the restrictions imposed in 1980 were too tight, Congress included provisions in the Tax Equity and Fiscal Responsibility Act (TEFRA) (PL 97-248) to ease the limits. The arbitrage limit was increased to 1.25 percent; the first-time homebuyer rule was given a 10 percent safety-valve exclusion; and the sales price limits were raised from 90 percent to 110 percent of average acquisition cost for the area (120 percent in targeted areas).

The experience of bond issuance under these restrictions indicates that, with limits, revenue bonds for housing can be used successfully. The limits established by the 1980 Act, as modified by TEFRA, may need further tuning to achieve the proper balance between high volume and targeted benefits, but the recent history of the bonds indicates that their use can be controlled and their implicit Federal subsidy can be directed to those who cannot be adequately served by the private market.

Reflecting this recent history, MBA no longer opposes categorically the issuance of home mortgage revenue bonds. Rather, on May 17, 1983, the Board of Governors adopted a revised statement of policy on the subject of tax-exempt bonds for housing, as follows: "MBA supports using municipal tax-exempt bond issues to provide funds for home mortgages, provided such issues are targeted toward meeting the needs of the disadvantaged, that is, the low-income, the elderly, and the handicapped. Further, such programs should be simplified and strict standards applied to make them less costly to homeowners and easier to work with for all participants. Moreover, if used, such programs should only be available to housing finance agencies which allow all types of originators and servicers to participate in all their programs."

Therefore, MBA supports enactment of HR 1176, "The Housing Financing Opportunity Act of 1983," introduced by Representatives Thomas J. Downey, Bill Frenzel, and many cosponsors. This legislative measure simply would delete the tax exemption expiration date from the Internal Revenue Code by restating Section 103A(b) without the expiration clause. It would not ratify or otherwise endorse the current purchase price ceilings, nor preclude subsequent fine tuning to target the proceeds from revenue bonds toward encouraging homeownership by the disadvantaged, that is, people with relatively low incomes, or who are elderly or handicapped.

Preliminary findings of a study being conducted by the General Accounting Office (GAO) raise a question whether revenue bonds for housing are currently restricted so as adequately to target the proceeds to disadvantaged persons. In its April 18, 1983 report, "The Costs and Benefits of Single-Family Mortgage Revenue Bonds: Preliminary Report," addressed to the chairman of the Senate Finance Committee, the GAO found "that most subsidized home loans were not made to low- and moderate-income households in need of assistance, but rather to those who probably could have purchased homes without assistance." Whether the final report will reach the same conclusion remains to be seen, of course, but, if the study does result in evidence that the Federal tax exemption is being used widely for people who are not low income families, handicapped, or elderly, a careful adjustment of the Federal law should be made.

In reviewing the final results of the GAO study, observers should be aware that it was conducted on activity occurring during 1981 and 1982—a period of record increases in home mortgage interest rates and market distortions brought about by these increases, as well as the high rates actually reached. Because of the rapid increase in the cost of financing, the private market was accessible only to a few. Now that home mortgage interest rates have dropped to more normal levels, the private market is again serving moderate-income homebuyers. Whether the states generally will exercise restraint and offer tax-exempt revenue bond assistance only to those disadvantaged people who cannot be served by the private market may not be answered by the study results alone.

Deductibility of home mortgage interest

Current law allows homeowners to deduct the interest paid on home mortgages, fully and without direct or indirect limit. MBA believes the tax deductibility of home mortgage interest is consistent with this Nation's long-standing commitment to homeownership opportunities for all American families. MBA opposes any restrictions upon this deductibility. Such restrictions could increase homeownership costs at a time when a reduced number of American families can afford to purchase a home. Limitations on interest deductibility would also discriminate against current homebuyers whose interest expenses, due to the high level of prevailing interest rates, are far higher than those of existing homeowners with mortgage loans that carry interest rates below current rates.

Additionally, at a time when our Nation's housing finance markets are being increasingly integrated with the Nation's capital markets, homebuyers would at a severe disadvantage in the competition for funds if the interest deduction for home mortgages is singled out for restriction.

MBA recognizes that the proposals to limit deductibility directly have been put aside, for a while, in response to the resounding Congressional expression against them in the previous Congress. But indirect attacks on the full deductibility continue to surface. Proposals to cap aggregate non-business interest deductions for an individual, for example, are indirect attacks on the deductibility of home mortgage interest. MBA urges the Committee to reject any attack, direct or indirect, on the full deductibility of home mortgage interest payments.

Miscellaneous

Several other provisions of current tax law recognize that, in addition to shelter, a house or condominium serves as the repository of the individual savings of many Americans. State and local property taxes are deductible as they would be for any other real estate investment, and a tax must be paid on the profit realized upon the sale of the house, but the profit tax is tempered by the allowance for an exemption of $125,000 for persons nearing or reaching retirement age. This recognition that equity in the home is the foundation of the retirement plan of many older citizens, coupled with the ability to defer any profit-tax while the house, or a substitute, is being used for shelter, allows the home to provide a mixed set of benefits, efficiently and fairly. MBA urges the Committee to recommend that no changes be made in the tax laws to discourage homeownership.

ENCOURAGING THE AVAILABILITY OF CAPITAL

In a sense the foregoing sections are a discussion of provisions that encourage the direction of capital toward real estate investment. There are several provisions, which are in the current tax law, or which could be adopted, that can encourage the availability of capital in the aggregate.

Income exclusions

Currently, individuals are allowed to exclude from taxable income a portion of the dividends and interest they receive each year. Somewhat analogous, corporations are taxed at a lower rate on the first $100,000 in profits annually. Each of these reductions of tax tends to encourage the small, marginal investor to dedicate capital to investment, rather than to expend funds for consumption. MBA has consistently supported responsible efforts to encourage capital formation, and, therefore, MBA urges the Committee to recommend that the current income inclusions be expanded rather than restricted.

Qualified pension plans and IRA's

There are a group of tax law provisions that are slowly becoming of particular importance to the development of real estate, and show promise of becoming more important. The ability to defer taxation of current additions to qualified pension plans and individual retirement accounts (IRA's) has encouraged individuals to save. Pension funds have grown geometrically in the past several years, and every indication is that they will continue to do so in the near future. Historically, pension funds have not been invested heavily in real estate, but pension funds are increasingly being seen, in the eyes of mortgage bankers and other lenders, as a logical source of real estate finance because their liability structures are longer-term in nature, and more closely match mortgage maturities than the liability structures of most other investors. For pension funds, the high yields and increasing marketability of mortgages should make attractive investments. MBA urges that individual long-term saving continue to be encouraged by the tax treatment of retirement funds.

Capital for real estate

Several technical provisions are directed to those business organizations that devote capital to real estate. Depository institutions are allowed to allocate income to a bad debt reserve without paying tax on the allocated income. We note that mortgage bankers are not currently allowed this bad debt reserve treatment. Historically, mortgage bankers sold the mortgages that they originated to long-term investors, and so did not bear a risk of loss if the debt went bad. However, recently, mortgage bankers have become issuers of securities backed by mortgages, and, as such, have begun to realize losses when mortgages are not paid. MBA suggests that the allowance of a bad debt reserve for mortgage bankers should be considered by the Committee.

In addition to bad debt reserves for depository institutions making real estate financing available, Congress allowed the establishment of a special set of accumulators of capital for real estate, the real estate investment trusts (REIT). REITs survived the economic challenge of the mid-seventies and have proven successful as entities encouraging capital formation. Current law does not allow the REITs to retain income and manage a reinvestment program, which leaves them unattractive vehicles for certain types of investors. Reducing the percentage of income the REITs must distribute on a current year basis would further encourage their ability to attract capital. MBA urges the Committee to recommend that REITs, and other entities issuing mortgage-backed securities, be allowed to retain and manage a larger portion of their annual income.

MBA appreciates the opportunity to comment on the subject of increasing tax revenues and the timing of revenue increases. We would be pleased to furnish any additional information that may be needed.

Sincerely,

JAMES M. WOOTEN, *President.*

STATEMENT OF CARL T. CURTIS, ON BEHALF OF THE NATIONAL ASSOCIATION OF ROYALTY OWNERS

Mr. Chairman, may I express my sincere thanks for the opportunity to testify before this Committee. I say today as I said on an earlier occasion, that I treasure the experience that was mine in the 10 years it was my privilege to serve on this Committee.

I am here to speak for the National Association of Royalty Owners or NARO. NARO is a national association headquartered in Ada, Oklahoma. While I speak under the auspices of NARO, I want to speak on behalf of every individual royalty owner. They have a case that is unique, and it is different from the situation of any other group of taxpayers in the land.

Who are these oil royalty owners? Well, in the first place, they are not OPEC. OPEC is not covered by the Windfall Profits Tax. It is estimated that there are 2.5 million royalty owners scattered throughout the United States. Naturally, there are more in the oil producing states than elsewhere, but they migrated to every state in the Union. The oil royalty owners are individuals who have no part in fixing the price of gasoline or heating oil. The oil royalty owners are without any means to control the production of petroleum. They couldn't organize a Cartel. These royalty owners cannot control imports nor do they have anything to do with the cost of imported oil. By and large, these oil royalty owners are individuals of very modest means. An informal survey was made by the Oklahoma Bankers Association, and they found that the average royalty check amounted to approximately $200 a month.

A typical royalty owner might be a man or woman who owned a small family-sized farm upon which oil is found. This person or his or her children have struggled through the years to hang on to the farm, and have often denied themselves in order to pay the land taxes and the interest and principal on the mortgage. They have faced drought and crop failures, and other discouragements. Those who know the situation know that royalty income is earned income.

These are the citizens who, when the Windfall Profits Tax was passed, were taxed at the same rate as multinational oil companies. Can you imagine an elderly citizen living on social security, and an oil royalty check of $200 a month, having his royalty income increased by reason of the deregulation of oil and having that increased income taxed at a rate, in some instances, as high as 70 percent on top of all other taxes, including state and federal income taxes, severance taxes, and other taxes?

The Windfall Profits Tax is collected at the source, and many of these fine people had no knowledge of the Windfall Profits Tax until it was taken from their royalty checks.

Congress wisely acted to grant some measure of relief from this unjust situation. First, there was enacted a $1,000 credit against the Windfall Profits Tax. Many of the royalty owners had neither the knowledge nor the means to apply for the credit, and in the meantime, the government had the money which was desperately needed by the royalty owners to meet their ever increasing cost of living.

Later, the $1,000 credit was displaced by an exemption of two barrels per day, and that exemption is scheduled to be increased to three barrels a day beginning in 1984. This scheduled increase to three barrels per day is a commitment to the royalty owners made by the United States Congress. This commitment has been relied upon by the royalty owners. I am here today to implore this Committee not to repudiate that commitment.

One myth about royalty owners is that they keep every dollar received from a barrel of oil. In other words, many people assume that if a barrel of oil sells for $29, then the royalty owner puts $29 in his pocket as profit. This is not true. Royalty owners pay up to seven layers of taxes on royalty income in many states.

For example, on May 5 of this year, your Oversight Subcommittee received evidence from a royalty owner in Texas that she paid nearly 30 cents in local, state and federal taxes on every royalty oil dollar before the windfall profits tax. Adding the bite of the windfall profit tax resulted in this particular royalty owner paying over 50 percent of her royalty income in taxes.

An Illinois royalty owner, living in Chicago, testified at the May hearings that he pays federal, state, oil lease tax, and real estate taxes on his land.

A resident of Columbia, Maryland testified that he pays not only the windfall profits tax, but also real estate, mineral, school, and gross production taxes to the State of Texas, income taxes to the State of Maryland, Howard County, Maryland and, of course, the federal government.

The point is that royalty owners are heavily taxed. The royalty owner does not keep every dollar in royalty oil income. He also has few of the deductions and credits the Tax Code provides for oil and gas producers. It is wrong to assume that applying the windfall profits tax to the third barrel of royalty oil means that "untaxed" income will be taxed. Instead, applying the windfall tax to the third barrel applies a heavy additional tax on people who can ill afford the additional burden.

I am aware that not all royalty owners are individuals with low income. There are royalty owners of middle income, and a few, very few, royalty owners of wealth. We know that this is true because the report of the Bankers Association of Oklahoma states that the average check was $200 per month, and took into account royalty checks both large and small. However, a good case can be made for the royalty owner who receives a sizable amount of royalty income. The Windfall Profits Tax is an unjust tax and no other segment of our economy is faced with a similar tax. The Windfall Profits Tax is in essence an excess profit tax, and no such tax is applied to any other group of taxpayers.

If an individual, whose income is from some source other than oil, has an increase in income, he is not taxed by a special windfall profits tax on his increased income. Our federal income tax is a graduated tax, which is applied alike to all taxpayers, regardless of their source of income. It is a stiff tax. I can cite some illustrations to show how individuals whose income comes from oil, such as royalty owners, are treated differently than any other taxpayers in our country.

(1) Suppose a professional man suddently, through good fortune, has income in a sizable amount, greater than his previous earnings. He pays more through our graduated federal income tax, but there is no windfall profits tax for him.

(2) Take the case of a young lawyer, who is making $35,000 per year, and through hard work he makes a success of some litigation and finds that his income is $80,000 a year. We do not apply a windfall profits tax to that lawyer, nor should we.

(3) Let us take the case of another young lawyer who is making $35,000 per year, and he makes a race for Congress and is successful, and is elected. Should we apply a windfall profits tax to him on his increased income?

(4) Let us consider the merchant who, because of other economic developments in his community, enjoyed a decided improvement in his business, and has profits greatly in excess of his profits of prior years. We apply no windfall profits tax to that merchant, nor should we?

Why should we treat royalty owners different than any other individual taxpayers in the whole land?

We could go on and cite other illustrations, all of which prove that income from oil is treated differently than income from any other source This is a discrimination, and it is very unjust.

I hope the time soon arrives that Congress can repeal the Windfall Profits Tax entirely. Until that can come about, the royalty owners should be completely exempted from the Windfall Profit Tax. In the meantime, the commitment made to the royalty owners to raise their exemption from two barrels a day to three barrels a day should not be violated or repudiated.

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION

SUMMARY

The National Cattlemen's Association (NCA) would strongly prefer that there be no tax increases at this time. The problems of the federal deficit should be attacked by systematic, substantial reductions in federal spending. However, if Congress believes that taxes must be increased, the tax increase should not penalize savings and investment.

In particular, NCA has the following comments with respect to various revenue increasing proposals:

(1) The proposed freeze of the phase-ins of the increases in the unified credit for estate tax and the reductions in the maximum estate tax rate should not be enacted because these taxes penalize savings and investment and present substantial hardships for ranchers, farmers, and other small businessmen.

(2) Indexing should not be repealed because it serves to prevent hidden tax increases by reason of inflation and repeal of indexing would encourage increased, not reduced, government spending.

(3) The scheduled increase in the used property limitation for property eligible for the investment tax credit should not be repealed because the used property limitation penalizes persons seeking to enter capital intensive buinesses, such as farming, ranching, and many other types of small businesses.

(4) The Administration's plan for contingent surtaxes on individuals and corporations and a $5-per-barrel excise tax on domestic and imported oil should be rejected because of the uncertainty about whether conditions allowing imposition of the taxes had been met and uncertainty that this mix of revenue sources would be appropriate under conditions at the time the changes are scheduled to go into effect.

If tax increases are needed, Congress and the Administration should look first toward improvement of compliance and collection procedures. Thereafter, there should be serious consideration of a road-based consumption tax because such a tax does not penalize savings and investment as increased income or estate taxes would do.

STATEMENT

I. Introduction

The National Cattlemen's Association (NCA) appreciates this opportunity to present its view relating to the revenue increase proposals which are being discussed in hearings on the 20th and 21st of July, 1983. It is no secret that we would prefer to testify about cutbacks in government revenue collections, for NCA believes that the government on both the spending and revenue sides already plays too large a part in this nation's economy.

Given the realities of the situation, however, we believe it is appropriate for us to present our views relating various revenue increasing proposals which this Committee is considering in compliance with the budget resolution. It is our primary concern that any revenue increase not penalize savings and investment. For this reason, much of the testimony will focus upon negative aspects of certain proposed revenue increases.

II. Administration's contingency tax plan

In its budget for fiscal year 1984, the Administration included a contingency tax plan. Under this plan, contingency taxes, consisting of a five percent surcharge on individuals and corporations and a $5-per-barrel excise tax on domestic and imported oil would become effective on October 1, 1985. These contingency taxes would become effective only if the following three conditions are met: (1) Congress adopts the Administration's deficit reduction measures; (2) the unified budget deficit for fiscal year 1986 is forecasted by the Administration, on July 1, 1985, to be above two and one-half percent of GNP; (3) on July 1, 1985, the economy is growing. If the contingency plan were to become effective, it would remain in force for up to thirty-six months. The logic of this approach of raising revenues is to assure continuance of the economic recovery while maintaining pressure for lower government spending.

NCA remains concerned about current and forecast deficits because ultimately those deficits distort and eventually reduce economic growth. However, reduction of the deficit depends largely on reduced government outlays and more rapid economic growth. Higher tax revenues and lower entitlement payments will flow from faster economic growth and this will help lower deficits. But deficits will not decline (let alone disappear) unless there is a serious commitment to a reduced government spending. It has been 14 years since the federal budget was last in balance.

NCA concurs with the Administration's decision not to jeopardize economic recovery with higher taxes. Almost all of the increased revenue for 1984 and 1985 reflects the Bi-Partisan Social Security Plan and higher contributions to Civil Service Retirement and should be nearly neutral for economic growth. Similarly, taxes for 1986 through 1988 will not be increased unless the economy is expanding.

Unfortunately, NCA does not feel the Administration's contingency tax plan for 1986 through 1988 is workable. Assuming the three conditions noted earlier were met, taxes on personal and corporate income taxes would be subject to a 5 percent surtax and a petroleum excise tax of $5 per barrel would be imposed on domestic and imported oil. There would be uncertainty about whether the conditions allowing imposition of the taxes had been met. This would, in turn, adversely affect decision making and retard economic growth. Equally important, it is possible this mix of revenue sources would not be the proper mix under conditions two years forward. Certainly the excise tax on petroleum could distort relationships among energy sources and regions of the country as well as affect domestic and foreign energy development.

III. Freeze Proposal

Chairman Rostenkowski has proposed that projected revenues be increased by eliminating all scheduled tax reductions in the Tax Code which are currently scheduled to go into effect after 1983. The theory behind this proposal is that these scheduled tax decreases should not take effect while the government faces massive deficits and it is easier to eliminate these secheduled tax reductions than to find new sources of revenue.

The three provisions which would be subject to the freeze proposal that are of particular concern to NCA are: (1) the proposals that affect estate and gift taxes, (2) the repeal of indexing, and (3) the repeal of the scheduled increase in the amount of used property which is eligible for the investment tax, credit.

A. Estate tax freeze.—The Economic Recovery Tax Act of 1981 (the 1981 Tax Act) made a number of improvements to the estate and gift tax rules, including increasing the unified credit, decreasing the maximum rate of tax, providing for an unlimited marital deduction, and improving the provisions relating to special valuation of certain real property. Prior to the 1981 Tax Act, the unified credit for estate and gift taxes was generally the equivalent of an exemption of $175,625, and the maximum rate of these taxes was 70 percent. The 1981 Tax Act increased exemption equivalency of the unified credit and reduced the maximum rate as follows:

Year	Exemption equivalent	Maximum rate (percent)
1982	$225,000	65
1983	275,000	60
1984	325,000	55
1985	400,000	50
1986	500,000	
1987	600,000	

A part of Chairman Rostenkowski's proposal to eliminate all tax reductions scheduled to become effective after 1983 is freezing the exemption equivalent of the unified credit at $275,000 and the maximum rate at 60 percent.

Estate and gift taxes place a unique burden on farmers, ranchers and certain small businessmen because such businesses will often have to include from three quarters of a million to several million dollars of illiquid assets. A partial disposition of the property to pay estate taxes is often not feasible because doing so would leave a unit which is too small to be economically viable. Borrowing to pay estate taxes is often not feasible because of the other credit needs of the ~~business or the~~ costs of servicing the debt. Furthermore, because of the low rate of return on farm and ranch assets, most farmers and ranchers cannot afford to provide a fund for estate tax liabilities through insurance or otherwise.

The estate tax laws encourage consumption and discourage savings, particularly where the savings are invested in illiquid assets in capital intensive businesses. This is unsound tax policy because increased savings and investment are crucial to keeping the economy growing.

In addition, the existence of estate taxes with high rates and applicability to substantial numbers of businesses encourages individuals to structure their affairs in manners which are motivated by tax minimization, not by attempts to find the most profitabe use of their assets. This structuring is inappropriate from a tax policy standpoint. All individuals should be encouraged to utilize their assets to maximize the rate of return, not to avoid estate taxes.

NCA believes that the phase-in of the maximum rate of tax and of the unified credit were not designed to adjust for anticipated future inflation. The primary justification for the decrease in the maximum rate of tax was that a 70 percent rate is too high, just as a 70 percent maximum income tax rate was considered too high. Consequently, both maximum rates were reduced to 50 percent by the 1981 Tax Act. The maximum tax on capital should not exceed the maximum tax on the income generated by the capital.

Similarly, although some may argue that future increases in the unified credit are not needed because the rate of inflation has dramatically decreased, this argument overlooks the principal reasons for increases in the unified credit. First, increases in the unified credit were not intended to compensate for inflation as can be seen by the fact that the increase far outpaces any reasonable 1981 estimate of what inflation might have been. Rather, the phase-in was done because of revenue concerns in the early years, and the $600,000 figure was deemed to be an appropriate exemption level. Second, one of the principal reasons for the increase in the credit was that estate tax exemption had remained at $60,000 from 1942 to 1976 (and the gift tax exemption remained at $30,000 for many years prior to 1976) even though inflation had effectively cut the value of the exemptions by two-thirds. Thus, the 1976 changes in the exemption level which were phased-in over five years were not even sufficient to adjust for the 1942–1976 inflation and did not take into account, or anticipate, the substantial inflation from 1976 through 1981. Furthermore, the increases in the exemption level in 1976 failed to adjust adequately for the fact that many types of small businesses, including family farms and ranches, had become much more capital intensive since 1942. The 1981 changes, when fully phased in, were intended to address this concern.

Another reason to oppose changes in the provisions added in 1981 is the need for continuity. Many farmers, ranchers and small businessmen have altered their estate plans in reliance on the new provisions. To require them to revise their estate plans again within two years would be costly and would further the cynical attitude which many businessmen have developed after nearly a decade of almost continuous major revisions of the Tax Code.

For the reasons stated above, NCA strongly opposes the proposal to eliminate the scheduled increases in the exemption equivalent of the unified credit and the scheduled decreases in the maximum rate of the estate taxes. This position is in accord with the position taken by the Treasury Department in testimony before the Estate and Gift Tax Subcommittee of the Senate Finance Committee on June 27, 1983.

In response to the proposal to freeze the estate tax rates and unified credit, a House resolution, H.R. Res. 216, has been introduced. This resolution, which has nearly 100 co-sponsors, would express the sense of the House that changes in the federal extate tax laws which were made by the 1981 Tax Act are vital to the continuation of family farms and small businesses, and such changes should not be repealed or amended, but rather should be allowed to run their course. A similar Senate resolution, S. Res. 126, has 33 co-sponsors.

B. Indexing.—As a result of the 1981 Tax Act, the minimum and maximum dollar amounts for the marginal rate brackets (including the zero bracket) and the dollar amount of the personal exemption will be indexed each year beginning in 1985 to take account of inflation. Indexing adjustments will be based upon increases (or decreases) in the Consumer Price Index.

As part of the "freeze" proposal, indexing would be repealed. NCA has long supported the concept of indexing because it believes that, without indexing, the automatic tax increased resulting from the effects of inflation are unfair to taxpayers because the tax burden as a percentage of income could increase without a change in economic circumstances, with an adverse effect on incentives to work and invest. In addition, failure to index provides the Federal Government with an automatic increase in its aggregate revenue which increases the government's propensity to increase spending. The indexing provisions enacted in 1981 were intended to prevent inflation from increasing the percentage that the taxpayer's tax liability bears to the taxpayer's income and thus would avoid the past pattern of unlegislated tax increases and spending induced thereby.

C. Used property limitation on investment tax credit.—Prior to the 1981 Act, only $100,000 of used property per year qualified for the regular investment tax credit. The 1981 Tax Act raised the used property limitation from $100,000 to $125,000 for taxable years beginning in 1981, 1982, 1983 or 1984, and to $150,000 for property placed in service in years beginning after 1984.

As part of the freeze proposal, the scheduled increase in the amount of used property eligible for the investment tax credit from $125,000 to $150,000 would be repealed.

NCA opposes freezing the used property limitation because, in many situations, a person wishing to get into ranching or farming or other types of business operations can only afford to acquire the necessary equipment if he purchases used equipment. Also, given the capital intensive nature of farming, ranching and many other types of small businesses, the $125,000 limitation would not cover all of the equipment which is needed to begin business. Consequently, the scheduled increase in the used property limitation should be allowed to go into effect.

IV. Other proposals

NCA believes that Congress and the Treasury Department should make their first priority the improvement of compliance with existing tax laws and the collection of amounts due under existing tax laws. However, this compliance action should not impose undue administrative burdens on taxpayers.

If additional revenues are needed, Congress may wish to examine a tax based upon consumption although NCA has not studied the area thoroughly and does not have specific recommendations. Nonetheless, NCA believes that, because income and estate taxes are already too high and these taxes penalize savings and investment, a consumption-based tax merits further attention.

V. Conclusion

NCA strongly prefers that the problem of federal deficits be dealt with by greater attention to the spending side rather than tax increases of any sort. This would have the salutary effect of reducing the Federal Government's role in the economy.

If tax increases are considered, NCA believes that it is imperative that certain items of the "freeze" proposal not be adopted. These objectionable provisions include eliminating the phase-in of the unified credit applicable to estate and gift taxes, elimination of the phase-in of the reductions in the maximum rate of the estate and gift taxes, repeal of the indexing provisions, and repeal of the scheduled increase in the amount of used property eligible for the investment tax credit. Although NCA applauds the intent of the Administration's proposal on contingency taxes, NCA believes that this proposal is unworkable because of uncertainty and substantial questions as to whether the particular mix of revenue increases now proposed would be appropriate in 1985.

If additional tax revenues are required, it is suggested that Congress give attention to further improvements in compliance and to consideration of a broad-based tax on consumption which would not penalize savings and investment in the manner that income and estate taxes do.

STATEMENT OF D. MICHAEL MURRAY, LEGISLATIVE COUNSEL, ON BEHALF OF THE NATIONAL COUNCIL OF COAL LESSORS, INC.

In 1951, after thorough consideration and extended debate, Congress enacted legislation that classified contracts which dispose of coal in place as sales, making the net proceeds capital gain or loss, under U.S. Code 631(c).

Fair taxation of proceeds given to a landowner from the sale of coal has been a problem since the incone tax was first instituted. The problem stems from the peculiar nature of the investment. After coal lands are first purchased they may lie undeveloped for decades, only showing a return on investment when an operator is persuaded to begin mining. Once this mining begins, however, it is inevitably on such a scale that the proceeds to the landowners would be taxed at the maximum rates. Therefore, there is really no graduated income tax for owners of coal lands, only the maximum tax.

There was no great problem when the income tax was first instituted. At that time the maximum rate was only 7 percent. But when the rates soared, particularly during the war years and early 1950's, this maximum taxation was recognized as inequitable. Not only did it grossly overtax coal landowners, it was poor public policy since it was hindering the development of United States coal reserves and directly contributing to the increasing costs of domestic energy. The legitimacy of this problem was recognized by Congress and remedied.

Not only does the capital gains treatment contribute to the solutions of the problems facing the coal and steel industries, it is the proper theoretical treatment for the sale of coal. Coal property is purchased as an investment, much the same as one would buy stock or any other capital asset. The only difference between coal and most other capital assets, one that weighs even more in favor of the present tax treatment, is that it is only disposed of very gradually over an extraordinarily long period of time. In some cases, coal lands may not be touched for over half of a century. It is hardly the type of investment that would be made by a speculator trying to manage a quick shift from regular to capital gains status.

For the following reasons, we would consider any change in the present tax structure most inequitable and ill-advised and urge that the capital gains treatment be retained for coal.

"The fact that coal is a nonrenewable resource would dictate the policy of efficient development and management of coal lands so that American energy self-sufficiency is not compromised. Any change in the present tax structure would conflict with Administration and Congressional policies to promote healthy American business activity while reducing unemployment and curbing foreign business infiltration."

Such coal contract dispositions are, in essence, sales of coal with a retention of an economic interest. The payments; therefore, are treated as proceeds of a sale and not as rent. Many long-term contracts that range from 20 to 60 years have been executed in reliance of capital gains treatment of gains realized on royalties. The Lessors, under these contracts, would suffer severe and unjust financial hardship if a change in tax classification were to be made before the contracts were complete.

The loss to the Treasury Department on capital gains treatment of money received for disposition is relatively small. This is because a substantial percentage of the coal property is owned by corporations which distribute income as dividends, taxable as ordinary earned income. The Joint Committee on Taxation's 1984-1985 estimated federal tax expenditure figures for the coal industry did not take into consideration the severe economic conditions in the coal industry. Because of the current economic conditions, royalty payments on coal will be extremely low, if not non-existent.

There is no doubt that coal pays its fair share of taxes. State severance and gross receipts taxes generally result in lower royalties for Coal Lessors. Land companies that made a profit paid an effective Federal tax rate of 34 percent in 1980, which is a much higher percentage than most major industries.

A change in the sales classification would result in higher domestic coal prices, which would increase energy costs and in turn, cause steel prices to soar; thus inviting more foreign imports which already threaten the survivors of the industry.

Currently, the coal industry is experiencing economic hardship. Presently, capacity utilization is at 67 percent. Metallurgical coal, which is crucial to steel production, is now operating at only 48 percent of capacity. In the first quarter of 1983, the unemployment level in the coal industry was at 75,000—compared with 40,000 unemployed in July of last year. This brings the national unemployment rate for this depressed industry to 31.6 percent.

More distressing news emanates from eastern coalfields where almost 50,000 members of United Mine Workers (UMW) are out of jobs. The latest unemployment figures collected by the UMW in mid-January are shown in the table below. They exclude non-UMW miners. In West Virginia, the nation's second largest coal producer, the employment picture is at an 80-year low with one out of five workers idle. In Gary—one of the richest metallurgical coalfields—a 90 percent unemployment rate prevails. Also in that state, only 35 percent of the current mines are active with 700 of the 2,000 surface operations and 400 of 1,100 underground producing any coal. The West Virginia State Department of Mines claims, however, that companies fortunate enough to be in business had better safety records, increased productivity, and very favorable labor relations, which is not necessarily consoling to those idle.

UMW UNEMPLOYMENT FIGURES AS OF MID-JANUARY 1983

State	Unemployment	Percent of work force
Alabama	2,582	25.8
Illinois	2,889	17.3
Indiana	1,321	35.7
Kentucky	5,839	41.6
Ohio	3,230	53.9
Pennsylvania	7,948	37.9
Virginia	2,852	27.4
West Virginia	18,574	38.1
District 14: Missouri, Kansas, Iowa	326	27.1
District 15: Colorado, New Mexico, Washington, Montana, Alaska, North Dakota, Sheridan County in Wyoming	1,051	33.8
District 21: Arkansas, Oklahoma	201	40.4
District 22: Utah, Arizona, Wyoming	1,146	25.5
Total unemployment of UMW	47,959	
Total UMW active work force	160,000	
Total UMW membership (including pensioners)	230,000	

It is essential for the development of the coal industry, for the survival of the steel industry, and for a form of cheaper energy for consumers, that this committee preserve the capital gains tax for coal.

STATEMENT OF THE NATIONAL FOREST PRODUCTS ASSOCIATION AND THE SOUTHERN FOREST PRODUCTS ASSOCIATION

The National Forest Products Association is a federated association that represents over 2,500 forest product companies and 32 regional and national forest industry associations on matters affecting the use and management of timberlands, the growth and harvest of timber, and the manufacture and utilization of forest products.

The Southern Forest Products Association is an organization of manufacturers with operations in Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North and South Carolina, Oklahoma, Tennessee, Texas, and Virginia. SFPA member mills account for three-fourths of the total southern pine lumber output and also produce quantities of softwood plywood and pulpwood.

Private nonindustrial landowners control 58 percent of the nation's commercial forest acreage and supply approximately 48 percent of the total harvest.

In the South, this group owns three of every four commercial forest acres and supplies two-thirds of the raw material for softwood lumber and plywood production and three-fourths of the pulpwood production. The dependency of the forest industry on the nonindustrial private sector will increase appreciably in the years ahead as the South becomes an even more important source of wood for the nation as a whole by the end of this century.

Unfortunately, the current rate of timber growth on the huge aggregate of nonindustrial private ownerships is less than the potential. Obviously, this problem must be resolved for the nation and the region to be able to meet its anticipated future responsibility as a supplier of forest products. One of the most important needs is a continuation of the improvement in tax incentives which encourage tree planting and the practice of forest management by private landowners.

While the federal estate tax has been a comparatively small source of revenue for the Federal Treasury—some $6 billion a year—it has, in many cases, had an extremely depressing effect on forest management motivations of the nonindustrial private owners.

Exorbitant estate taxes have forced many heirs to sell timber prematurely, to the detriment of both the land and themselves. Additionally, forced sale of the land itself to pay taxes is not uncommon.

High estate taxes also discourage current forest owners from improving and managing their lands, knowing both the land and timber may well have to be liquidated by their heirs to pay taxes. In many cases, land sold under these conditions is converted to non-timber use, thus reducing the timber supply base.

The first major constructive step in the direction of federal estate tax reform occurred in 1979 when Congress voted to repeal the carryover basis rule of estate taxation. If left untouched, this add-on to the 1976 tax bill would almost certainly have resulted in massive dissolution of family-held forestland.

Further improvements were achieved in the 1981 Economic Recovery Act, including an increase in credit from $275,000 for people dying this year to $600,000 for people dying after 1986. Also provided was a decrease in the maximum rate from 60 percent for people dying in 1983 to 50 percent for decedents dying after 1984.

But obviously, this progress would be nullified if a proposal by Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee, should be approved by the Congress. Among other things, Rep. Rostenkowski suggests a freeze on statutory federal tax reductions scheduled to go into effect after this year. That, of course, would wipe out the hard-won gains in the estate tax area, much to the detriment of private forestry.

Progress, not retrogression, is needed in estate tax reduction. That is why both the National Forest Products Association and the Southern Forest Products Association wholeheartedly support Senate Resolution 126 introduced by Senator Wallop which opposes any changes in the estate tax provisions of the Economic Recovery Tax Act of 1981.

Beyond that, both Associations support current legislation calling for repeal of the estate tax on grounds that it is confiscatory and costs more money than it returns to the Federal Treasury. The Associations also support legislation which would repeal the generation-skipping transfer tax, and proposals for further reduction in the maximum rate as well as expansion of the range of estates eligible for special use evaluation.

The Associations are well aware that further reductions of the estate tax may not be feasible in a year when enormous federal budget deficits are projected. But, at the very least, the Congress should act to retain those reforms and improvements already enacted into law.

STATEMENT OF PATRICK B. HEALY, CHIEF EXECUTIVE OFFICER, NATIONAL MILK PRODUCERS FEDERATION

The National Milk Producers Federation is the national farm commodity organization representing dairy cooperative marketing associations owned and operated by dairy farmers throughout the nation. Most of the nation's milk supply is marketed through the cooperative associations represented by the Federation. It is the only organization whose policy represents a national consensus of dairy farmers. As such it has long been interested in legislation, including that relating to estates and gifts, which directly affects the structure and effectiveness of dairy farms.

We recognize the necessity of consideration of revenue increase proposals by the Ways and Means Committee. The Federation, however, is deeply concerned at any effort to freeze the estate tax exemption at its present level.

On June 5, 1981, we testified in support of increasing the estate tax exemption. At that time we showed that the value of the average commercial dairy farm—one with 50 to 60 milking cows operating 300 to 400 acres of land—approximated $600,000. Therefore, even with the $600,000 exemption any family dairy farm above this average faces the likelihood of having to pay estate taxes.

We have been deeply concerned about the impact of this tax on the ability to transfer family farm operations from one generation to the next. In our 1981 statement we pointed out the necessity of increasing the estate tax exemption. This need has not changed. The lack of liquid assets in family farm operations continues to make them vulnerable to being divided up if a substantive estate tax is imposed.

In our testimony at that time we urged the immediate adjustment to the $600,000 figure. This was not done; instead the $600,000 figure was reached by a phase-in over a period of years extending to 1987. While we were not happy with this protracted approach we recognized it as a proper step toward establishing a reasonable estate tax base.

Since adoption of the 1981 law the value of a commercial dairy operation has changed only slightly, but the change has been toward an increased value, in part because of inflation and in part because the average sized herd continued to increase in number.

A freeze on the estate tax exemption would cap it at $275,000. To do so is not to retain the status quo as some might think. Instead it is a step backward. It would perpetuate the problem we are attempting to have overcome—the jeopardizing of a family farm structure in order to pay estate taxes.

House Resolution 216 expresses the sense of the House that the changes in the estate tax exemption provided in the Economic Tax Recovery Act of 1981 proceed on schedule. We support this resolution and trust it will serve to deter those who have advocated a freeze by showing that the House is not so disposed.

We therefore urge no change in existing law, thereby extending the estate tax exemption to the $600,000 total without any freeze being imposed.

STATEMENT OF STEPHEN DRIESLER, EXECUTIVE VICE PRESIDENT, NATIONAL MULTI HOUSING COUNCIL

Mr. Chairman and members of the Committee on Ways and Means, my name is Stephen Driesler. I am Executive Vice President of the National Multi Housing Council. The National Multi Housing Council (NMHC) is a non-profit organization with over 5,000 members representing all aspects of the multifamily housing industry. The National Multi Housing Council's members include many of the nation's largest builders, developers, syndicators and managers of rental housing. In fact, I think it would be accurate to say that NMHC's members build, own or operate more apartment units than those of any other association in the counrty today. In addition, our members primarily build and operate rental housing without direct government subsidies.

In announcing these hearings, Chairman Rostenkowski stated: "The Committee on Ways and Means has always taken seriously its responsibilities under the Congressional Budget Act. Beginning with the first reconciliation instruction to the Committee in 1980, the Committee has always met its targets in a responsible manner. The seriousness of the long-term economic projections dictates as realistic a response to the fiscal year 1984-86 target as can be achieved. As a result, in these hearings the Committee seeks testimony not only as to approaches to raising the necessary revenues, but testimony as to their timing as well, given the fragile nature of the current economic situation."

It is the fragile nature of the current economic situation with regard to investment in residential rental property which I wish to address in my remarks.

The flow of investment capital into the rental housing industry is strongly dependent upon provisions in the tax law, particularly those regarding the cost recovery period. Without each and every advantage rental housing now has in the tax code, the apartment industry would be unable to compete effectively in the capital markets.

The simple fact is that with today's high cost of land, materials and money, market rents generally do not creat an income stream which is competitive with other types of investments. Add to this the level of risk associated with any real estate venture. and you find that we in the rental housing industry are already at a competitive disadvantage compared to the rate of return an investor can get with a money market certificate or other "no risk" investments.

During the past few years Congress and the Administration have either eliminated or drastically reduced the federal rental housing program. This is especially true in the area of new construction. Therefore, whatever new rental housing will be built in this country in the foreseeable future must come form the private sector. If, however, the private sector cannot attract sufficient capital to build or maintain apartments, who will meet the housing needs of America's renters? The answer is no one.

These points were underscored by a recently published study by the Department of Housing and Urban Development entitled Federal Tax Incentives and Rental Housing which according to Secretary Pierce, "documents the close and significant relationship between federal tax and housing policies".

The study concludes by saying: "Notwithstanding, the favorable treatment of rental housing under the 1981 [Tax] law, there could be a flow of some investment capital out of rental housing and into the construction of office buildings, shopping centers and other non-residential buildings . . . this potential movement of investment capital away from rental housing could be reinforced by the substantially more attractive tax allowance than were available under the previous Code for machinery and equipment. The simplified and spruced-up capital recovery system and increased investment tax credit favored non-residential investments".

A similar conclusion, that residential real estate came out of the '81 tax act at a competitive disadvantage, was reached by Jane Gravelle, Specialist in Taxation for the Library of Congress. In her study Effects of the Accelerated Cost Recovery System by Asset Type, Ms. Gravelle found: "there may be well be a shift in the composition of capital towards business equipment and away from structures, particularly away from residential structures. The relative (and perhaps absolute) size of the housing stock could fall". If this should occur, and I submit the evidence shows that there is a diversion of capital away from rental housing under the existing tax code, any effort to take away or further reduce the tax advantages rental housing now has would be disastrous to the industry and the country.

From a public policy point of view, the HUD study also found that the consumer is the ultimate beneficiary of tax advantages given to rental housing. After careful analysis of the competitive nature of the rental housing market, HUD found: "It is likely that most of the benefits to owners and investors under the Economic Recovery Tax Act (ERTA) will accrue to tenants in the form of lower rents than would be the case without ERTA".

"Owners of rental property may benefit by themselves in the short run from a favorable change in rental tax provision. However, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in the absence of the favorable change. Since renters have lower incomes than other households, tax benefits that lead to decreased rents tend to be progressive in nature."

Obviously, the converse of this finding is equally true. Any changes in the tax code which would reduce the flow of capital into rental housing or drive up its costs would ultimately result in higher rents and shortages of affordable housing and would be regressive in nature.

The last point I wish to raise in opposition to any changes in the current tax code as they relate to real estate generally is the matter of consistency. Real estate investment by its very nature is a long-term proposition. The building of an apartment complex usually taxes a couple of years from the time the project is first conceived until it is built and rented. Apartments almost never generate a positive cash flow until they have been operating for many years.

Typically when one investments in real estate one is looking at five to ten years before expecting to realize any real profit from the investment.

No one knows what inflation or other economic factors are going to be that far in the future and that is part of the risk any real estate investor takes. Nevertheless, an investor must base his decision on the tax laws of today. If an investor does not have some degree of confidence that the tax law is going to remain consistent for at least a reasonable period of time, then this uncertainty multiples his risks manyfold and drastically reduces the likelihood that anyone will make such a long-term investment.

The Accelerated Cost Recovery System (ACRS) changes have only been in place for about two years and they are beginning to work in the residential real estate field. New construction of apartments is increasing, as is investor interest.

To change these incentives now would cause a substantial reduction in real estate construction and stifle the economic recovery which it has helped to produce.

Any reduction in existing tax incentives for rental housing would further exacerbate an already severe shortfall in the number of units needed to meet present and future rental housing requirements, and would result in higher rents to tenants.

Finally, any reduction in tax incentives for rental housing would cause great uncertainty on the part of investors, owners and developers and would be unfair to those who have entered into long-term economic commitments based on the current 15 year cost recovery schedule.

STATEMENT OF E. WAYNE THEVENOT, PRESIDENT, NATIONAL REALTY COMMITTEE, INC.

I. INTRODUCTION

The National Realty Committee, Inc. (NRC), a non-profit business league of owners and developers of commercial, residential and other real property throughout the United States, submits this statement in response to the announced review by the Committee of various methods to increase Federal revenues. The NRC understands that this review is prompted by the immediate need of the Committee to "locate" additional revenue to comply with the First Concurrent Resolution on the budget for fiscal year 1984 which requires the Committee to report legislation which increases revenues by a total of $73 billion between fiscal year 1984 and 1986.

The NRC intends to address itself to the role of real estate in the U.S. economy, the degree of sensitivity within the real estate sector of the economy to tax law changes, and the 15-year capital cost recovery period for real property under ACRS. In short, the NRC contends real estate's role in a healthy U.S. economy is significant; real estate's sensitivity to tax law changes is substantial; and, due to this sensitivity, an extension of the current 15-year ACRS recovery period to a longer period, as suggested by some to increase Federal revenues, would result in decreased, rather than increased, Federal revenues and an exacerbation of the historical tax bias against investment in structures.

II. WHY NRC OPPOSES EXTENSION OF 15-YEAR ACRS WRITEOFF PERIOD

In order to raise additional revenue and reduce the Federal deficit, suggestions have been made, in particular by the Congressional Budget Office, to lengthen the recovery period for depreciable real property under ACRS from 15 years to 20 years. Simply put, the NRC opposes any such extension of the recovery period for depreciable real property for a series of reasons.

A. ACRS, including the portions thereof applicable to real property, was intended to produce increased investment and savings; it has done so. (see attached Table 1 and Chart 1). It continues to do so.

While the economy has been picking up and the worst ravages of inflation have abated, large areas of the country still require economic rejuvenation, unemployment is still too high (twice the national average in the construction industry), and inflation, while moderated, is still a force to be reckoned with.

The problems for which ACRS was an intended remedy are therefore still with us.

B. The 15-year recovery period for real property represented a compromise. In 1981, during the debates attending the introduction of ACRS, substantial sentiment existed in favor of the 10-5-3 depreciation system under which real property would have been assigned a 10-year recovery period, twice the recovery period for most machinery and equipment. The NRC did not support 10-5-3, with its attendant 10-year recovery period for depreciable real property, but did ultimately support the ACRS 15-year recovery period for real property, even though this resulted in a recovery period for depreciable real property that was 3 times as long as that applicable to most machinery and equipment.

Extending the recovery period at this time for depreciable real property to 20 years would have the effect of increasing recovery period ratios between real and personal property from 3-1 to 4-1. There is no apparent justification for such a disparity. All evidence indicates that effective tax rates applicable to real property investments already substantially exceed those applicable to manufacturing (See attached Table 3).

C. ACRS was enacted less than 2 years ago. Rapid changes in fundamental tax law affecting investment assets create unnecessary and counterproductive uncertainties in investment markets. At this point, there is nothing to be gained by lengthening real property recovery periods and everything to lose. The direct Treasury revenue gains that would result from the stretch-out would only apply to property placed in service by a taxpayer after the effective date of the change, and the change itself would dampen the rate at which real property would be newly placed in service. In fact, investment in real property structures would substantially decrease, dangerously close to pre-ACRS levels (See attached Chart 3). Calculations performed by Coopers & Lybrand for us indicate that for the immediate future the revenue effect of the change would be negative (See Table 2), thereby voiding the reason for which the 15-year ACRS period would be extended, i.e., to raise Federal revenues.

III. NRC'S ECONOMIC STUDY

Since 1972 the NRC has actively involved itself in a continuing economic study of the place occupied by the real estate industry in the United States economy. For many years Dr. Norman B. Ture worked as a consultant with the NRC in this endeavor. His independent work and work in behalf of the NRC during the 1970's resulted in the development of two economic forecasting computer models, one for the entire U.S. economy (ATIM) and one, a submodel proprietary to NRC, for the real estate subsector of the United States economy.

As a result of Dr. Ture's association with the NRC, the NRC published in 1973 and 1977 comprehensive economic studies of the place held by real estate in the U.S. economy. These studies made it clear to all, including Congress, that real estate is a major actor in the U.S. economy which must be taken fully into account when a tax bill is considered. Key aspects of this study have been updated through 1981.

Building on the ATIM model, the accounting firm of Coopers & Lybrand has developed an economic forecasting simulator, called CLEFS, which can analyze the effects of various proposed tax law changes on the economy and on investment in real estate. CLEFS can be used in conjunction with the NRC's real estate submodel (now updated by Coopers & Lybrand) to render greater detail and information regarding the effects of such tax changes on the real estate sector of the economy.

To better prepare its case before Congress in 1983, and to assist the Committee in its review of certain tax expenditures, NRC asked Cooper & Lybrand to assess through the use of CLEFS the comparative gain or loss to commercial and rental residential real estate investment stemming from the 1981 tax bill (ERTA) and the 1982 tax bill (TEFRA). And because the option was contained in the Congressional Budget Office's February 1983 report entitled "Reducing the Deficit: Spending and Revenue Options" NRC also asked Coopers & Lybrand to analyze the effect extension of the current 15-year ACRS writeoff period for structures to 20 years would have on Federal revenues and investment in the real estate sector. The results arrived at by Coopers & Lybrand are contained in Section V of this statement.

IV. REAL ESTATE IN THE U.S. ECONOMY

Its role is significant and its sensitivity to tax law changes is substantial.

Both the NRC's updated economic study of real estate's role in the economy and the output of CLEFS indicate that the industry is highly sensitive to tax changes to which it is exposed. Given the demands by real estate on other industries and the dependence of virtually all economic sectors on the products and services of the real estate industry, tax changes which adversely affect real estate impede progress throughout the economy.

Three sets of findings support these observations:

A. The real estate industry—defined as private contract construction, real estate services, and financial services allocated to real estate—is the fourth largest U.S. industry.

In 1981, real estate produced $275.5 billion—12.2 percent—of private business sector's GNP.

Real estate has made a major contribution to the long-term expansion of total output of the U.S. economy. Since 1947, real estate GNP has increased at an average annual rate of 3.3 percent, about the same rate as that for the total private business sector (measured in constant 1972 dollars). The industry's growth slowed considerably after 1970; its constant dollar GMP growth rate fell to 2.4 percent for the years 1971-1981, compared with 3.0 percent for the total private business sector in the same period.

The real estate industry provided 5,966,000 jobs in 1981, about one out of every 12 in the private sector. Employment in the industry grew almost a third again as fast as in the private sector as a whole from 1947 through 1981. (2.1 percent in real estate vs. 1.6 percent in the private sector as a whole.)

The physical structures which are the real estate industry's principal final products are a major part of the total stock of real capital in the United States. In 1981, the value of privately-owned structures was nearly 4.2 trillion. The amount of this capital measured in constant dollars has increased at an average rate of 3.5 percent a year since 1947, but has grown at a much slower rate—2.6 percent—since 1971.

B. While very large in terms of total output and employment, the real estate industry consists predominantly of a very large number of very small business establishments.

In 1980, there were almost 417,000 contract construction and almost 170,000 real estate service establishments. These firms are important parts of the business life of every state and city.

Over 90 percent of the contract construction establishments employ 20 or fewer employees.

95 percent of real estate service establishments employed 20 or fewer persons.

C. Demands by the real estate industry generate substantial amounts of income and employment throughout the U.S. economy.

In 1981, nearly 2.4 million employees in other industries were producing things required by the real estate industry.

With the nearly 6 million persons employed directly in real estate, total employment generated by real estate was about 8,350,000, about one of every 9 jobs in the private sector.

The National Income generated in the real estate industry and in other industries in meeting real estate demands amounted to about $303 billion in 1981—about one-eighth of the U.S. National Income.

These facts afford a sharp perspective about the real estate industry. It is a highly fragmented industry with a major impact on the American economy. Yet, because it is predominantly an industry of very small, nondiversified business units, real estate is unusually susceptible to changes in broad economic conditions, in the financial climate, and in public policies.

The historical record also shows that the vigorous long-term growth of the real estate industry has not generated comparable increases in returns to investors. Over the period 1947 through 1981.

Gross pretax equity income—proprietors' income, corporate profits, personal rental income, and depreciation allowances (all in current dollars)—increased at an average annual rate of 6.8 percent compared with 8 percent for total current dollar GNP originating in real estate.

As a share of real estate GNP, gross pretax equity income has declined steadily, from almost 64 percent in 1947 to less than 44 percent in 1981.

In view of these trends, tax policy makers should carefully evaluate the effects of their policy decisions on the capacity of the industry to attract the saving which, in real terms, finances investment in real estate. Increasing the rate of tax on the returns on such investment will mean retarded growth in the stock of private housing and industrial and commercial structures.

Our study also details the contribution of the real estate industry to the financing of the public sector. In 1979, the industry generated just over $41 billion in Federal tax receipts, about 8.4 percent of total Federal tax revenues. In the same year, real estate accounted for close to $70 billion of taxes at the state and local government level, about 29 percent of these government's tax receipts.

Slowing the growth of real estate, it should be clear, sooner or later must also retard the growth in state and local governments' financial capacity to provide public services.

The conclusions to be drawn from the preceding profile of the real estate industry are virtually inescapable:

The private real estate industry plays a large and critical role in the American economy.

It is the financial mainstay of our states and localities.

The future capability of the industry to contribute to the economy's growth and well being will depend heavily on the weight of taxes on real estate investment. Tax changes adverse to the industry's growth will affect all segments of the economy and every region, state, and locality in the United States.

V. CLEFS'S ANALYSIS OF THE IMPACT OF CAPITAL RECOVERY CHANGES IN 1981 AND CBO'S PROPOSED CHANGE IN 1984 ON ECONOMIC ACTIVITY

The following tables and charts have been prepared for the National Realty Committee by Coopers & Lybrand. The analysis was performed using Coopers & Lybrand's Economic Forecasting Simulator (CLEFS).

Three simulation runs were done. A baseline case was run assuming pre-ERTA capital recovery provisions. This is identified in the following exhibits as the "prior law" simulation. A second simulation was run reflecting the changes in the capital recovery provisions due to ERTA. This "present law" case includes changes made as a result of TEFRA. The final simulation is of a change from 15 to 20 year depreciable lives for all structures.

As can be seen in Table 1, equipment was given advantageous treatment relative to structures as a result of the ERTA capital recovery changes. If the lives for all structures are increased beginning in 1984, the simulations show a decline in investment and Federal tax revenues from what would otherwise be the case (see Table 2).

A significant effect of the increased lives for structures is to heighten the historical disparity in the treatment of equipment relative to structures. Table 2 shows that the capital stock level for equipment would increase relative to the "present law" case. However, the capital stock level would decrease relative to the "present law" case for structures. Furthermore, commercial and rental residential structures would tend to be pushed back to simulated pre-ERTA levels (see Table 2 and Chart 3).

TABLE 1.—COMPARISON OF PRESENT LAW (ERTA AS AMENDED BY TEFRA) TO PRIOR LAW TRENDS

	1981	1982	1983	1984	1985	1986	1987
Differences from prior law (billions of dollars):							
Investment	18.8	23.1	28.3	35.0	41.9	48.3	55.6
Federal tax revenues	.6	1.2	1.6	2.8	3.8	5.1	6.9
Investment (1972 dollars)	10.4	12.0	13.6	15.7	17.8	19.4	20.9
Federal tax revenues (1972 dollars)	.4	.6	1.1	1.3	1.6	2.1	2.6
Capital stock (1972 dollars):							
Equipment	18.8	19.6	23.1	26.0	27.3	30.3	33.8
Commercial and rental residential structures	13.4	15.0	15.0	17.5	22.3	26.1	30.2
Percentage differences from prior law:							
Investment	4.12	4.61	5.25	5.12	5.55	5.88	6.01
Federal tax revenues	.07	.11	.17	.22	.29	.37	.46
Investment (1972 dollars)	4.13	4.63	5.28	5.15	5.57	5.88	5.98
Federal tax revenues (1972 dollars)	.11	.19	.34	.35	.44	.54	.64
Capital stock (1972 dollars):							
Equipment	3.15	3.11	3.46	3.78	3.77	4.00	4.28
Commercial and rental residential structures	2.84	3.09	2.96	3.30	4.03	4.55	5.02

Note.—Prepared by Coopers & Lybrand for the National Realty Committee (June 27, 1983).

TABLE 2.—COMPARISON OF PROPOSED LAW (20-YEAR LIFE FOR STRUCTURES) TO PRESENT LAW TRENDS

	1984	1985	1986	1987
Differences from prior law (billions of dollars):				
Investment	-10.6	-13.0	-15.6	--18.2
Federal tax revenues	-.3	-.5	-1.0	-1.5
Investment (1972 dollars)	-4.7	-5.5	-6.2	-6.9
Federal tax revenues (1972 dollars)	-.1	-.4	-.4	-.6
Capital Stock (1972 dollars):				
Equipment	5.9	5.6	5.3	4.8
Commercial and rental residential structures	-20.4	-22.4	-24.5	-26.9
Percentage differences from prior law:				
Investment	-1.48	-1.64	-1.79	-1.86
Federal tax revenues	-.06	-.05	-.07	-.10
Investment (1972 dollars)	-1.48	-1.64	-1.79	-1.85
Federal tax revenues (1972 dollars)	-.03	-.17	-.10	-.14
Capital stock (1972 dollars):				
Equipment	.82	.75	.67	.58
Commercial and rental residential structures	-3.63	-3.84	-4.01	-4.19

Note.—Prepared by Coopers & Lybrand for the National Realty Committee (June 27, 1983).

TABLE 3.—COMBINED CORPORATE AND PERSONAL EFFECTIVE TAX BURDENS ON NEW INVESTMENT UNDER ALTERNATIVE TAX SCHEMES

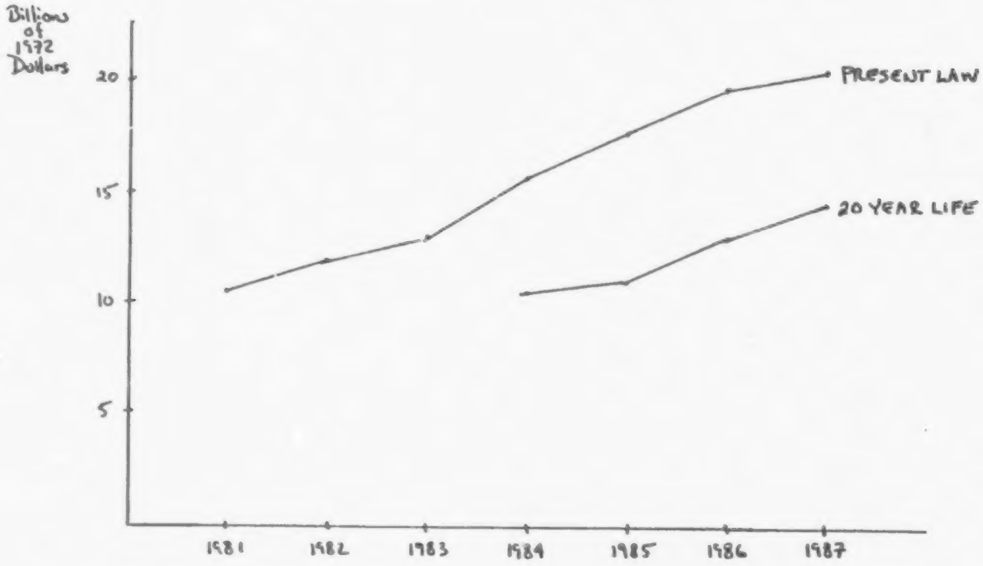
[In percent]

	Inflation	
	6 percent	9 percent
Fixed capital:		
A. Pre-1981 law:		
Equipment	26	31
Public utility structures	36	37
Other structures (primarily buildings)	52	52
B. Permanent ACRS provisions:		
Equipment	-12	-5
Public utility structures	25	26
Other structures	43	43
C. Current law (TEFRA):		
Equipment	21	26
Public utility structures	35	35
Other structures	43	43
Land	53	50
Inventories	66	65
Combined aggregate tax burdens:		
Pre-1981 law	48	48
Permanent ACRS provisions	39	40
Current law (TEFRA)	44	45
No corporate tax	33	38
Expensing of investment	13	7

Source.—"Effective Corporate Tax Rates and Tax Changes in the 97th Congress", Congressional Research Service, The Library of Congress, Jane G. Gravelle, Specialist in Industry Analysis and Finance, Economic Division, January 3, 1983.

Chart 1

Gross Private Domestic Investment - Differences from Prior Law (Pre-ERTA)

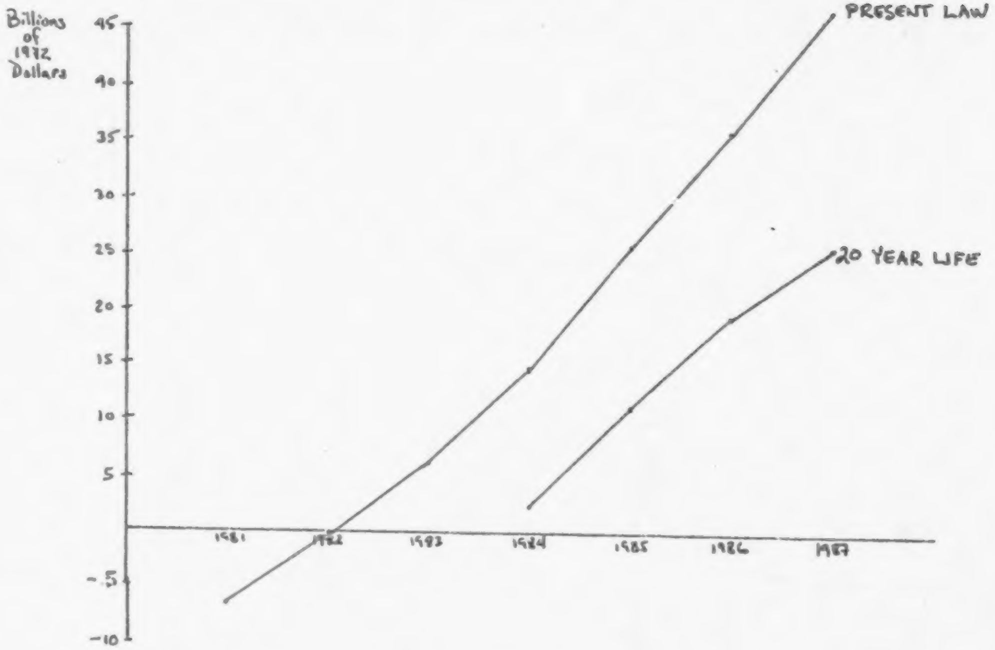


Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

Note: Gross Private Domestic Investment consists of purchases by private businesses of fixed capital goods (equipment and structures) plus the value of the change and the physical volume of inventories held by private businesses.

Chart 2

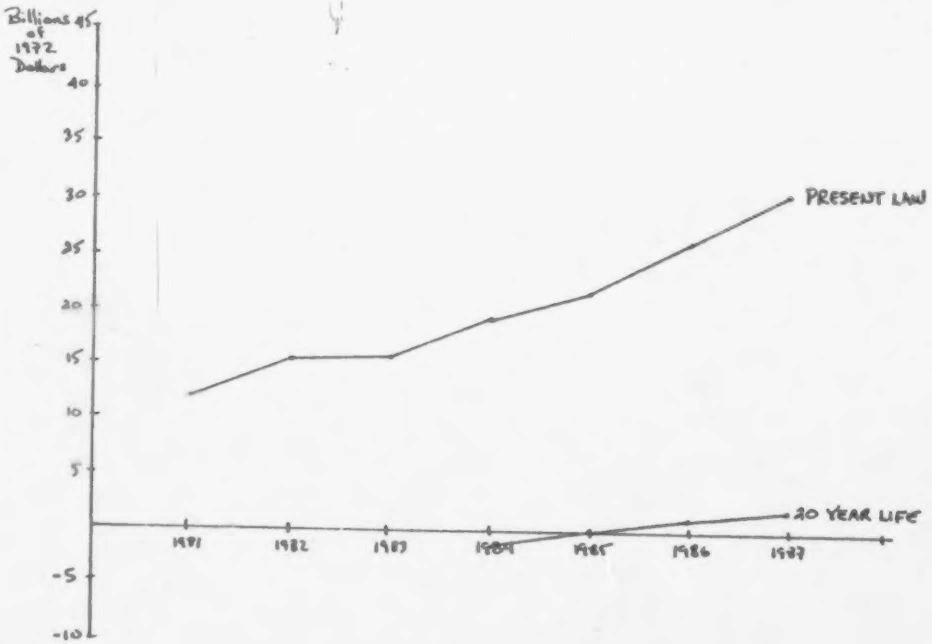
Stock of Structures - Differences from Prior Law (Pre-ERTA)



Prepared by Coopers & Lybrand for the National Realty Committee
(6/27/83)

Chart 3

Stock of Commercial and Rental Residential Structures - Differences from Prior Law (Pre-ERTA)



Prepared by Coopers & Lybrand for the National Realty Committee
(6/27/83)

STATEMENT OF THE NATIONAL RESTAURANT ASSOCIATION, SUBMITTED BY RONALD A. SARASIN, DIRECTOR OF GOVERNMENT RELATIONS

The National Restaurant Association is a non-profit trade association with headquarters in Washington, D.C. It offers programs in public affairs, education and research to its 10,000 members, who operate more than 100,000 food service facilities.

As Director of Government Relations, I am pleased to have the opportunity to discuss methods for increasing taxpayer compliance and to comment on our industry's experience under the tip reporting measures of the Tax Equity and Fiscal Responsibility Act of 1982.

Section 314 of TEFRA and the proposed regulations published this spring are intended to increase compliance among restaurant employees by establishing new reporting requirements for operators.

In the past, restaurant operators reported to the IRS only the amounts reported to them by their employees as tip income received. Under the new law, employers will report the following information: the gross receipts of the establishment, the total amount of charge receipts on which there were charged tips, the aggregate amount of charged tips, and the employees' aggregate reported tips. With this information, the IRS expects to be equipped to evaluate the level of tipping which is customary for a particular establishment and make a determination as to the level of compliance by the restaurant's employees.

In addition, the 1982 law and present regulations go further and require the operator to determine on a payroll-to-payroll basis what the level of tip reporting is as a percentage of gross sales. If the employees as a group are not reporting an amount of tip income that reflects 8 percent of the establishment's gross sales, (or a lesser percentage as determined by the District Director, but not less than 5 percent of gross sales), the employer must calculate the amount of the shortfall. That amount must be "allocated" to each employee who did not report an amount equal to his proportionate share of the 8 percent gross. An employee's share is to be determined from his hours or from his individual gross sales, as a percentage of the total.

I would like to comment on two issues which have arisen under the tip reporting provisions that I have just described.

The law itself is complicated—so complicated that District Offices of the Internal Revenue Service across the country are referring questions to us. We have held over 100 seminars in 41 states in order to educate our members; however, this barely scratches the surface of the industry. I believe that the level of compliance will be adversely affected by the sheer complexity of the law.

Secondly, the law establishes a procedure for which there is no precedent in the tax code—it requires a third party to make an estimate of income which was earned in a transaction between two other parties. The employer-operator of a restaurant has no way of knowing the actual amount paid in tips by customers to his employees. Requiring him to make this estimate and place it on his employee's W-2 form has not only created management problems for him, but is alien to basic American notions of fairness.

I would like to propose a solution to these problems which I believe would aid our industry in complying with the law, and would be useful to the Committee in shaping new compliance measures.

The NRA's firm position is that all Americans should pay their fair share of taxes. We also recognize that increasing taxpayer compliance is preferable to increasing taxes. However, we have learned a great deal since the new tip reporting law was enacted—valuable lessons that we feel compelled to share with this Committee before it considers further legislation to improve taxpayer compliance.

The allocation procedure should be replaced by a simplified reporting scheme. Such a change would make the law less burdensome yet provide the Congress with the revenue it seeks. In fact, adoption of a simplified procedure like the one I will suggest may result in revenue increases over and above the present estimates. A request for information on the revenue effects of this proposal has been made to the Joint Committee on Taxation and to the Treasury Department by the Hon. Henson Moore of this Committee.

I would ask the Committee to drop the unworkable and unfair allocation requirements from the law, and substitute in its place a requirement that the employer will report the following additional information: charged tip income for each individual, individual reported tips, and the individual's hours worked or gross sales.

This information, while calling for a preliminary computation and for proper record-keeping by employers, clearly simplifies the procedures when employees are not reporting at the 8 percent level, and provides the Internal Revenue Service with complete information for evaluation—not merely the numerical result of a hypothesis which has no basis in fact.

It has the advantage of providing the IRS with the information needed to locate unreported income in establishments where tipping may be as high as 20 percent, which will yield far more revenue than the present policy of chasing after employees who earn only 5-8 percent in tips.

After due consideration, I hope the Committee will agree that my discussion of our experience with the new compliance measures has proven useful, and also that the proper fine-tuning can give us a more workable, less burdensome way to ensure proper compliance by restaurant employees.

STATEMENT OF DAVID L. KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION

SUMMARY

The National Taxpayers Union is opposed to any tax increases at this time. Passage of tax increases now would burden the fragile U.S. economy and make the federal tax system more oppressive.

Adjusted for inflation, taxes will reach new record highs by fiscal year 1986 and every year thereafter under current law.

Income tax indexing was the most important reform of the 1981 Economic Recovery Tax Act and must be preserved. Income tax indexing provides "truth in taxation," will help control inflation, and may prevent a return of stagflation.

It would be inappropriate for Congress to approve the contingency tax plan without also approving spending reductions at least as large as those proposed by the Administration. The contingency tax, as proposed by the Administration, should be rejected.

The surtax relies on raising marginal tax rates to raise revenues, one of the most harmful ways to raise taxes per dollar of taxes collected.

The trigger may contribute to political pressures to increase spending.

The economic trigger to the contingency tax is poorly designed, allowing it to be triggered as the economy goes into a recession.

The National Taxpayers Union also rejects base broadening, unless it is accompanied by sufficient reductions in the marginal tax rates so as to produce no net revenue gain. All Americans would be better off if Congress enacted a simplified flat rate income tax plan.

An amnesty program should be developed to bring non-filers and those taxpayers who have not reported certain types of incomes into the system. An amnesty program would bring more tax revenues into the system, while benefitting those taxpayers who need a fresh start.

STATEMENT

Mr. Chairman, and members of the Committee, I am pleased to submit this statement on behalf of the over 120,000 members of the National Taxpayers Union.

The National Taxpayers Union is opposed to any tax increases. Taxes are at near record-high levels, and further tax increases would burden our fragile economy and make the federal tax system more oppressive. We strongly urge the Committee not to report favorably any tax increase legislation.

The myth of reduced Federal revenues

There is a myth that the 1981 Economic Recovery Tax Act (ERTA) has caused a dramatic loss of federal revenues. Nothing could be further from the truth. Adjusted for inflation, federal revenues for fiscal year 1985 will be the second highest in our nation's history. In fiscal year 1986, and for every year thereafter under current law, federal revenues, again in constant dollars, will reach record-high levels.

As table one clearly shows, the amount of the inflation-adjusted federal revenues expected in 1984 is almost identical to the amount collected in 1980. In 1985, the real increase is expected to be almost $28 billion. By 1988 this real increase will reach $118.3 billion.

Virtually all of the increase in the federal deficit since 1980 is the result of the failure of the President and Congress to control federal spending.

To control the federal budget deficit, the President and Congress must control federal spending. The American taxpayer is already expected to pay record-high amounts of federal taxes.

TABLE 1.—CONTINUED REAL GROWTH OF FEDERAL TAXES

[Dollars in billions]

	1980	1984	1985	1986	1987	1988
Baseline revenues	$517.1	$653.9	$717.8	$773.5	$827.1	$882.4
Social security law		+8.2	+5.2	+8.1	+9.2	+19.7
Total baseline revenues	517.1	662.1	723.0	781.6	836.3	902.1
1980 revenues, adjusted for inflation		664.2	695.4	726.0	755.1	783.8
Dollar increase over 1980 revenue base, adjusted for inflation		−2.1	+27.6	+55.6	+81.2	+118.2
Percent increase over 1980 revenue base, adjusted for inflation		−0.3	+4.0	+7.7	+10.8	+15.1

Note.—The GNP deflator was used to adjust for inflation. Estimates for GNP deflator for 1983–88 from February CBO baseline.
Source.—National Taxpayers Union Staff Computations.

Income tax indexing must be preserved

Starting in 1985, the bracket amounts and the personal exemption will be indexed to the increase in the consumer price index from the previous year. Without indexing, as a worker's income increases to keep up with inflation, he is forced into higher tax brackets—whether or not his real income has increased. The result is that every taxpayer pays a larger percentage of his income in taxes, without an increase in real buying power. This effect of inflation on the tax system is known as "bracket creep" or "taxflation." The Joint Committee on Taxation has estimated that for every ten percent of inflation, income taxes increase 16.5 percent.

Several members of Congress have proposed repealing income tax indexing. This would be a serious mistake. Personal income tax indexing was the most important provision in the 1981 Economic Recovery Tax Act.

In the tax increase proposal by Chairman Rostenkowski to repeal all tax reductions scheduled to take effect after December 31, 1983, almost three of every four dollars would be raised by repeal of income tax indexing. Even though it would raise approximately the same amount of revenue as the President's contingency tax proposal over fiscal years 1985 through 1988, repeal of indexing would soon cause the Chairman's proposal to exceed the tax increases generated by the contingency tax plan. In fact, if inflation reaches double digits, the Chairman's proposal could easily raise many tens of billions of dollars more taxes than the contingency tax.

Such tax increases would probably come at the worst possible time. If inflation picks up, the tax increases from repeal of indexing will likewise increase. If this occurs, chances are that the country will be in another period of "stagflation." The lack of indexing would only worsen the situation by producing large and automatic annual tax increases when the economy can least afford them.

One of the most common myths about indexing is that somehow it cuts government revenue. The truth is that indexing does not cut one penny off federal revenue. All that it does is prevent unlegislated increases in taxes. Revenues would not decrease. With indexing, if inflation increases 5 percent, income tax revenues increase 5 percent.

In fact, if the economy grows, revenues would still rise faster than the rate of inflation. For instance, if real income increased by 10 percent during the next five years, income tax revenues could be expected to grow by 16 percent. This is in addition to the proportionate growth caused by inflation. Rather than cutting revenues, indexing would allow for real growth of federal revenues—but only due to the actual increase in the standard of living, not inflation.

Principle reasons for indexing the income tax

Indexing prevents unfair automatic tax increases which dramatically affect taxpayers in lower and middle income tax brackets. As table two clearly shows, repeal of income tax indexing would cause steep increases in taxes over the next several years, even with relatively low inflation. These tax increases would affect taxpayers in different tax brackets differently. For example, a family earning $10,000 this year could expect to pay 46 percent more in federal income tax by 1988 if indexing is repealed. By contrast, the family earning $100,000 would pay 8 percent more in federal income tax in 1988. If inflation were to return to double digits, these tax increases would come about much more quickly. Tax increases for 1986 could instead closely resemble the tax increases that are currently in the 1988 column.

INCREASE IN TAXES FROM REPEAL OF INDEXING FAMILY OF 4, JOINT RETURN, 1 WAGE EARNER

1983 income is assumed to grow at the annual inflation rate	1985	1986	1987	1988	1985–88
$10,000 ($10,973 in 1985):					
Current law	$362	$379	$395	$410	$1,546
Repeal	408	470	533	599	2.010
Dollar increase	46	91	138	189	464
Percentage increase	12.7	24.0	34.9	46.1	30.0
$15,000 ($16,459 in 1985):					
Current law	$1,107	$1,159	$1,207	$1,254	$4,727
Repeal	1,174	1,298	1,411	1,523	5,406
Dollar increase	67	139	204	269	679
Percentage increase	6.1	12.0	16.9	21.5	14.4
$25,000 ($27,431 in 1985):					
Current law	$2,493	$2,610	$2,717	$2,823	$10,643
Repeal	2,568	2,786	2,986	3,183	11,523
Dollar increase	75	176	269	360	880
Percentage increase	3.0	6.7	9.9	12.8	8.3
$35,000 ($38,404 in 1985):					
Current law	$4,416	$4,624	$4,813	$5,001	$18,854
Repeal	4,558	4,919	5,274	5,626	20,377
Dollar increase	142	2985	461	625	1,523
Percentage increase	3.2	6.4	9.6	12.5	8.1
$50,000 ($54,863 in 1985):					
Current law	$8,124	$8,506	$8,854	$9,200	$34,684
Repeal	8,401	9,056	9,654	10,319	37,430
Dollar increase	277	550	800	1,119	2,746
Percentage increase	3.4	6.5	9.0	12.2	7.9
$100,000 ($109,725 in 1985):					
Current law	$24,687	$25,847	$26,907	$27,956	$105,397
Repeal	25,201	26,937	28,569	30,185	110,892
Dollar increase	514	1,090	1,662	2,229	5,495
Percentage increase	2.1	4.2	6.2	8.0	5.2

Source: National Taxpayers Union Staff Computations. All calculations assume income is from wages and with itemized deductions equal to 23 percent of adjusted gross income. For income levels at or below $15,000 in 1983, the zero bracket amount is used. Inflation assumptions are from the February Congressional Budget Office baseline for CPI-U: 1983 4.3 percent; 1984 5.0 percent; 1985 4.7 percent; 1986 4.1 percent; 1987 3.9 percent.

Repeal of income tax indexing would clearly hurt low income taxpayers most. Those in lower income tax brackets find it particularly hard to keep up with inflation—yet their taxes would increase most if indexing were repealed. This is because the distance between the brackets is smaller at lower income levels and thus taxpayers are more quickly pushed into higher tax brackets. They are also must more affected by the erosion in the value of the fixed amount exemptions. Since exemptions represent a greater percentage of a low income than a large one, any decrease in the value of these amounts will harm low income taxpayers most, especially those with large families.

Indexing will help to slow the growth of government spending.—An unindexed tax system is biased toward greater spending and a greater role for the public sector. If indexing is repealed, tax bracket creep would increase income taxes by $90 billion between 1985 and 1988.

By removing the government's ability to raise taxes without an explicit vote of Congress, indexing provides an incentive to control spending.

Indexing provides truth in taxation.—Without indexing, taxes are raised automatically each year with no legislative action or public debate. Not only are such safeguards as open congressional hearings and debates eliminated, but there are no recorded votes on the issue either in committee or on the floor. The entire political process is sidetracked.

Indexing would help curtail inflationary pressures.—Indexing removes an important incentive the federal government has to cause inflation. With indexing, the federal government would not receive a tax windfall during inflationary periods.

In addition, indexing allows labor to afford to moderate wage demands. Without indexing, labor unions bargain for wage increases by taking into account the expected increase in taxes due to inflation. This causes larger wage demands, leading to even higher labor costs. Indexing the tax system helps break this spiral.

Indexing helps prevent severe "stagflation".—Without indexing, not only would inflation undermine the value of each dollar earned, but a larger portion of these dollars would be taxed away. Savings and investment would also decrease as taxflation makes the rewards of such acts less certain. A study published by the Joint Economic Committee agreed, stating that the lack of indexing "is likely to produce stagflation." The study also concluded that "indexed taxes would have moderated the [economic] collapse of 1974."

Indexing enjoys widespread support.—Proposals to index state income taxes have appeared on ballots of three states since 1980. Each time the voters overwhelmingly approved tax indexing. A recent poll conducted by the U.S. Chamber of Commerce by The Gallop Organization found that respondents favored income tax indexing by more than a 2 to 1 margin.

The contingency tax

According to a Treasury Department fact sheet, the contingency tax plan would go into effect "only if three conditions are met: (i) Congress adopts the administration's spending reductions and structural reforms of federal entitlement programs, (ii) the unified budget deficit for fiscal year 1986 is forecasted by the Administration on July 1, 1985, to be above 2½ percent of GNP; and (iii) on July 1, 1985, the economy is growing." The contingency tax is to become effective only for "up to 36 months."

Tax increases of this magnitude should not be attempted without being accompanied by larger spending cuts. It would be inappropriate for the Committee to approve the Administrations' contingency tax plan without Congress also approving spending reductions at least as large as those proposed by the administration.

Although the details of such a contingency tax plan have not been revealed, some basic criticisms can be made. One very important goal of the ERTA was to reduce marginal income tax rates. A surtax would directly contradict that important goal by boosting marginal tax rates across the board for individuals and corporations. This would reduce incentives to save, to work, and to invest. Raising marginal tax rates in this manner is one of the most harmful ways to raise taxes per dollar of taxes collected.

A contingency tax plan would make economic planning more difficult for individuals and corporations. People make sounder economic decisions when they can be assured of the tax rates they can expect in the future. No one would know whether or not this contingency tax would go into effect until July 1, 1985, three months before its effective date.

Although the Administration says that the surtax could remain in effect for "up to" 36 months, it's not clear under what conditions it could be repealed before the 36 months are up. This, too, adds another element of uncertainty.

Finally, passage of such a contingency tax gives Congress and the President little incentive to control federal spending. Here's why. Passage of such a tax increase will be politically difficult. Once new taxes are approved, it will be tempting to pass new spending programs to reap politial benefits that will partly counter the political liability of the tax increase. Since one of the trigggers on the tax increase proposal is the size of the federal budget deficit, many members of Congress will push for new or higher federal spending, knowing that if the budget deficit is over 2½ percent of GNP, the new taxes will automatically go into effect to pay for the spending. No one spending bill will be seen as triggering this tax increase and no single member of Congress will be to blame for triggering the tax increase. If a trigger is to remain a part of this proposal, not only should there be a trigger for the budget deficit but another trigger which says that federal spending could not grow in real terms should be required.

The trigger that requires the economy to be growing as of July 1, 1985 is poorly designed. The economy might still be barely growing as it swings back toward another recession. For example, if the economy grows at an annual rate of 5 to 7 percent for the rest of this year and next, then declines to a paltry one-half percent growth rate by July 1, 1985, would anyone say that that is a good time to impose a massive tax increase? I doubt it. A better trigger would say that not only must the economy be growing, but that its rate of growth should be increasing.

Finally, the energy tax portion of the contingency tax proposal will unfairly hit harder at those taxpayers who live in colder states or those who must drive long distances to work. Resorts and vacation spots will find that their economies will be adversely effected.

After the energy tax initially goes into effect, it will be hidden in the price of consumer purchases. Taxpayers will not be able to easily calculate its dollar effect, which will reduce government accountability.

The contingency aspect of the energy tax will also make sound energy investment decisions more difficult. Energy producers and consumers already have a complex array of factors to consider without being hampered by new and higher taxes.

Another proposal to raise taxes is base broadening. Although base broadening can be the least harmful way of raising taxes, the National Taxpayers Union does not endorse base broadening unless it is accompanied by sufficient reductions in marginal tax rates so as to produce no net revenue gain. All Americans would be better off if Congress enacted a flat rate income tax plan, with a large standard deduction, low rates, and a vastly simplified tax system. Many steps can be taken in that direction.

There are two ways to raise revenues that we could support. First, Congress should not pass tax increase legislation. If Congress really began controlling federal spending, the prospects for continued long-term economic recovery would vastly improve. As the economy grows, more revenues will flow into the federal treasury. Some of this revenue could then be used to again reduce tax rates across the board, helping the economy to continue its growth.

A taxpayer amnesty program would help boost tax compliance, while also helping taxpayers. A properly designed amnesty program would benefit the IRS by bringing in untold billions of dollars from the underground economy into the light. The non-filer problem could be significantly reduced.

In the book When You Owe The IRS, author Jack Warren Wade, Jr. gives an example of a taxpayer who had not filed his returns for 11 years. Once the first filing deadline passed the taxpayer became too frightened to file in the following years. Even so, he would have been owed refunds for a total of $700 for the first six years. Then for the next three years, he owed money while in the last 2 years he was again due a refund, which in this case, was large enough to pay all the back taxes. That year he came in and filed the return with Wade, who was then an IRS employee. The taxpayer "admitted that this problem had been bothering him for all 11 years. He had suffered two heart attacks, an ulcer, a nervous breakdown and countless sleepless nights worrying about what would ever happen if he got caught."

No doubt there are many taxpayers who would like to surface, but are scared about what the IRS might do to them. An amnesty program would allow taxpayers to voluntarily disclose past due taxes without worrying about criminal prosecution and jail. A penalty and interest charge could still apply.

Here are some key positions that should be included in any amnesty plan: (1) Taxpayers seeking amnesty must not have already been contacted by the IRS for non-filing or for under-reporting; (2) The program should end within a defined time period; (3) Interest could be charged on back taxes. Penalties might apply, but it would be better if they were waived, save for the failure to pay penalty at 6 percent; (4) Taxpayers who came forward under the amnesty program should be allowed to enter into liberal installment agreements to pay their back due taxes, and, if appropriate, be eligible to have their tax liability waived if it is judged that it would be impossible to pay; (5) The IRS should not share amnesty tax returns with any other federal government agency for the purpose of discovering other violations of the law; (6) The IRS should not share its amnesty tax return information with any state or local income tax revenue authority. Otherwise, taxpayers might open themselves up to prosecution at the state and local level by disclosing their federal violations to the IRS; (7) Taxpayers who have filed fraudulent returns would not be eligible for the amnesty program; and (8) Tax liability should be limited to six years of tax liability, or net worth, whichever is more.

Other, more limited proposals for amnesty have been made, and they would be worthwhile too.

There is, evidently, a de facto voluntary disclosure amnesty policy which is known to sophisticated attorneys who specialize in tax fraud cases. But it's doubtful that the typical citizen is aware of such a policy. Instituting an amnesty program would end this double standard.

If this amnesty program brings out just 20 percent of the tax revenue that the IRS currently cannot get, that would total nearly $20 billion per year, almost as much as is required under the First Budget Resolution. No one's taxes would have been raised, and no taxpayer will be forced to pay higher taxes than currently required. We would prefer that additional revenues generated by this increase in tax compliance be used to reduce other people's tax rates. After all, a common claim made is that people who are already paying their taxes are paying higher taxes because some people are not. What better way to use the revenue from new taxpayers entering the system than to cut the tax rates for those who have been complying with the laws all along.

In conclusion, I hope the Committee will keep in mind that any tax increase will hurt economic growth by raising new or higher disincentives to production. At a time when federal taxes are expected to hit new record-high levels, a tax increase is uncalled for. If Congress wants to sustain a long period of economic recovery, it should control quickly act to federal spending, and, to the extent possible, reduce marginal tax rates.

STATEMENT OF BRUCE HAHN, MANAGER, GOVERNMENT AFFAIRS, NATIONAL TOOLING & MACHINING ASSOCIATION

Mr. Chairman and members of the committee, my name is Bruce Hahn. I am Manager of Government Affairs for the National Tooling & Machining Association. We very much appreciate your invitation to testify on revenue increase proposals.

Like most of the business community, we recognize the triple dilemma facing this committee. On one hand, the growing federal deficit threatens recovery by competing with the private sector for capital to finance the deficit, thus causing upward pressure on interest rates. On the other hand, tax increases could reduce the deficit, but they may also stifle economic recovery. If in fact such tax increases have a dampening effect on investment or savings, then they would raise less revenue than indicated by a static revenue model and could potentially raise little or no net additional revenue. The third part of the dilemma relates to reduction of the federal budgets. The realities of the budget are such that significant reductions are not realistic, at least from a political standpoint. Given all these factors, it is understandable why the committee has concluded that raising taxes may be the only practical means to reduce the deficit.

We believe that it is possible to increase taxes in a manner that will not significantly affect economic growth in this country. We also believe that most categories of taxes should not be increased because most would create a significant threat to economic recovery. Beyond that, we also believe that there are budgetary actions which are politically feasible and which should be a part of any action designed to reduce the deficit.

Let me begin by suggesting which taxes not to increase. The taxes which should not be increased are those which are most tied to job creation. Apart from the social aspects of job creation, a new job has a positive double effect on the economy and the federal deficit. First, it reduces the deficit directly by the elimination of one additional person from federal support. Secondly, it adds personal and business revenue to the taxable base.

Most new jobs in this country are created by small business. Small business, as a rule, is more labor intensive and, moreover, is almost entirely domestic in terms of its job creation. Increasing the tax burden on this sector, which is also the most innovative sector and the hardest hit by the recent recession, makes no sense at all.

Freezing further phase-in of the Economic Recovery Tax Act of 1981 would do just that. It would freeze three important provisions that are important to productivity and transfer of small business ownership. I am referring to the phase-in of expensing provisions, estate and gift tax exemptions and increasing the amount of used equipment eligible for the investment tax credit. The first and last provisons will increase productivity. The expensing provision greatly simplifies tax preparation for the very small company and it also encourages innovation. The used equipment provision enables small business, the primary purchaser of used equipment, to make an equal and balanced decision on productivity returns on a fair basis with respect to new equipment. Indeed, there is no economically rational reason for discrimination against used equipment. The estate tax provisions will prevent further break-up of successful small businesses, whether they be small manufacturers, retailers, wholesalers, or farmers.

Despite this negative introduction, we believe that taxes can be increased in a manner to have a positive effect on economic recovery. The solution is to restructure the tax system so as to collect more taxes from products which are imported while collecting those taxes in a manner which would not be illegal under the General Agreement on Tariffs or Trade.

The mechanics of such an effort would be relatively simple. Many of our trading partners use a value added or excise tax collected at the final point of sale. The rate of tax may vary among product lines and some products are exempt from the tax.

What we would propose is a similar tax in the U.S., targeted to specific products, and coupled with equivalent targeted tax reductions on the same products. Take the case of an automobile for example. An automobile manufactured in the U.S. to sell for $10,000 might include $1,500 in taxes collected in various ways along the chain of production and marketing. A similar imported automobile would contribute much less in U.S. taxes because its production, outside the U.S., is not subject to U.S. tax. What we would propose is that the total tax collected on automobiles be shifted so that most is collected in the form of an excise tax at the point of sale while the total taxes remained the same. Thus, a 10 percent excise tax would be coupled with equal tax reductions on any of the taxes collected during the manufacturing process. The total cost of the U.S. automobile would still be $10,000. Most of the tax, however, would be collected at the point of sale and very little, if any, would be collected during the manufacturing process itself. The imported car would not benefit from the tax cuts at the production end, since it was not manufactured here, but would still be subject to the excise tax. The total taxes collected on imported products would amount to new revenue, and the amount could be significant. At the same time, competing U.S. products would become more attractive in the U.S. because the price of competing imports would rise by the amount of the excise tax. U.S. exports would also become more attractive in other countries because the excise tax need not be collected on those products exported for final consumption elsewhere.

No doubt, our trading partners would object to such an effort as a thinly veiled means of collecting a tariff. We submit that we would only be doing selectively what most GATT members are already doing anyway. They collect proportionately more of their taxes at the point of sale because it puts their products on a more competitive basis both domestically and internationally.

The amounts of additional revenue which could be collected are enormous. In fact, they could be large enough to allow for additional modest tax reductions designed to further stimulate our economy. We suggest that you consider a package of proposals suggested by the Small Business Legislative Council, an alliance of over 70 trade associations whose members are predominantly small businesses. That proposal, along with a list of SBLC members, is attached for your reference.

In addition, there are ways of reducing the federal deficit. Right now, for example, the Department of Defense buys $13 billion worth of spare parts annually, procuring less than 10 percent of that through competitive bid. Many of you have seen recent articles in the Washington Post, New York Times or Wall Street Journal, or seen the issue of exorbitant price increases discussed on such programs as 20/20. What has not been publicized is that the issue has been studied to death and that several experiments have shown that savings average 50 percent when those parts are switched from sole source to competitive procurements. We suggest that you mention this to your colleagues on the Appropriations and Budget Committees as a means of saving about $6 billion each year without impacting our defense effort.

[Attachment]

SMALL BUSINESS LEGISLATIVE COUNCIL

American Association of MESBICs, American Association of Nurserymen, American Textile Machinery Association, Architectural Precast Association, Association of Independent Corrugated Converters, Association of Physical Fitness Centers, Automotive Service Councils, Inc., Automotive Warehouse Distributors Association, Building Service Contractors Association International, Business Advertising Council, Christian Booksellers Association, Direct Selling Association, Eastern Manufacturers and Importers Exhibit, Electronic Representatives Association, Florists' Transworld Delivery Association, Furniture Rental Association of America, Greater Washington Ibero-American Chamber of Commerce, Independent Bakers Association, Independent Bankers Association of America, Independent Media Producers Association, Independent Sewing Machine Dealers Association, Institute of Certified Business Counselors, International Association of Trade Exchanges, International Franchise Association, International Sanitary Supply Association, Machinery Dealers National Association, Manufacturers Agents National Association, Marking Device Association, Latin American Manufacturers Association, Menswear Retailers of America, Narrow Fabrics Institute, Inc.

National Association of Brick Distributors, National Association of Catalog Showroom Merchandisers, National Association of Home Builders, National Association of Minority Contractors, National Association of Plastic Fabricators, National Association of Plumbing-Heating-Cooling Contractors, National Association of Realtors, National Association of Retail Druggists, National Association of the Remodeling Industry, National Association of Trade & Technical Schools, National Automobile Dealers Association, National Beer Wholesalers' Association of America, National Candy Wholesalers Association, National Council for Industrial Innovation, National Electrical Contractors Association, Inc., National Family Business Council, National Fastener Distributors Association, National Independent Dairy-Foods Association, National Office Products Association, National Parking Association, National Patent Council, National Precast Concrete Association, National Shoe Retailers Association, National Small Business Association, National Society of Public Accountants, National Spa & Pool Institute, National Tire Dealers & Retreaders Association, National Tooling & Machining Association, National Tour Brokers Association, National Wine Distributors Association, Opticians Association of America, Power and Communications Contractors Association, Retail Bakers of America, Specialty Advertising Association International, United Bus Owners of America, United Federation of Small Business, Web Sling Association.

[Attachment]

STATEMENT OF SMALL BUSINESS LEGISLATIVE COUNCIL OF THE NATIONAL SMALL BUSINESS ASSOCIATION

SMALL BUSINESS TAX PROGRAM

Lower the amount of corporate tax liability up to $200,000 of taxable income. The tax imposed would be: 12 percent for taxable income not more than $25,000; 15 percent for taxable income greater than $25,000 but not more than $50,000; 20 percent for taxable income greater than $50,000 but not more than $100,000; 30 percent for taxable income greater than $100,000 but not more than $150,000; 40 percent for taxable income greater than $150,000 but not more than $200,000; and 46 percent for taxable income greater than $200,000.

Increase from 60 to 80 percent the capital gain deduction for equity investments in small business concerns if such investments are held for five years or more.

Establish a maximum corporate capital gain rate of 20 percent attributable to equity investments in small business concerns.

Allow a nonrefundable, 10 percent tax credit for an equity investment in a qualified small business.

Provide that if any property is sold by a taxpayer at a capital gain, the taxpayer may defer that gain by making an equity investment in a qualified small business within one year of the original sale. Also, the gain is only taxed to the extent that revenue from the sale exceeds the cost of the equity investment, thereby allowing at least a partial forgiveness of the capital gain.

Investment tax credit for used equipment.—The annual limitation for investment in used qualifying property for purposes of the investment tax credit should be increased to at least $250,000.

LIFO recapture.—Repeal the LIFO Recapture Provision (Section 403(b) of the Windfall Profit Tax Act.)

Inventory simplification.—Further simplify the tax accounting for inventories by allowing a single pool of goods for small business and the use of exogenous issues.

Minimum accumulated earnings.—The minimum credit for earnings which may accumulate before any accumulated earnings tax would apply should be increased to at least $500,000.

Independent contractors.—A safe harbor provision should apply to individuals historically treated as independent contractors and a withholding tax should not be required.

Debt-equity.—The debt-equity rules issued pursuant to Section 385 should be written to enable smaller firms to easily comply with the law.

Targeted jobs tax credit.—The targeted jobs tax credit would be expanded to a general jobs tax credit, which is preferable to greater spending on public employment.

Small business equity loans.—A lender would be allowed to make a loan to a small business at an interest rate lower than the prevailing rate; in return, the lender could receive a share of the small business' profits.

Expensing.—The amount of capital purchases eligible for the expensing option should be raised to $25,000.

ONE TAX ALLIANCE,
Arlington, Va., July 15, 1983.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: As requested by your office today, written statement herewith for members of the Committee, the printed record, the press and public.

In the summer of 1980, the Committee on Ways and Means held extensive hearings about tax cuts. (Serial 96–134.)

Many of the present committee's members heard that testimony.

Tax cuts, tax increases and adjustments have multiplied in the ensuing period, with disastrous results.

The One Tax Alliance presented a tax reform program, which went unheeded.

Now we are faced with mounting deficits as well as utter chaos.

The Committee invited proposals for revenue increases. Various proposals were listed as under consideration.

These would add to an already overburdened tax code, further confusing the public.

A ready revenue is immediately available through the suspension of all deductions, exemptions and credits in their accepted sense; substituting for each two-thirds value in the first year, one-third value in the second year and zero value in the third year.

Proper presentation by leadership will influence the people to accept their share of erasing our astronomical deficits, they having been on the receiving end of largess dispensed over the years.

Taxes are the price we pay for civilization. Responsible citizens feel their obligation, provided the achievement of social and economic ends is best left to a free and unfettered economy.

Relative to H.R. 3475 made part of this presentation, my publication "Taxes, Government" provides the answer to simplification. Each year beginning with the Tax Reform Act of 1976, followed by a report of the staff of the Joint Committee on Taxation and practically yearly, legislation dealing with simplification has been enacted. What is needed is simplification of the legislative process. Congress created it. Congress can simplify it. All it needs is the will. The people will back them.

Sincerely,

SAMUEL GREENBERG, *Chairman.*

STATEMENT OF JOHN L. NORMAN, NATIONAL DIRECTOR OF TAXATION, PANNELL KERR FORSTER

Mr. Chairman and members of the committee, my name is John L. Norman. I am National Director of Taxation for the international public accounting firm, Pannell Kerr Forster. We appreciate the opportunity to testify before this Committee to discuss the tax increases which are mandated in the recently passed fiscal year 1984 Congressional Budget Resolution.

Napoleon said, "Give me control of the purse and I care not who has the armies." He was only partially correct; you and your Senate colleagues by controlling the American tax system control the economic fate of this country and, indirectly, the welfare of the world.

Taxes are indeed the price we must pay for a civilized society. Yet we should pursue policies which permit the government to fund the requirements of that society as interpreted by its elected officials and still maintain a climate conducive to economic development and vitality. These dual responsibilities require you as statesmen and women to have political awareness and economic foresight. Having worked for a Member of this Committee and for a Member of the Senate Finance Committee, I know the difficult tasks which you have fulfilled consistently.

Now, however, you are confronted with another challenge: The mandate of the fiscal year 1984 Budget Resolution to raise approximately $73 billion in the next three fiscal years. The economy is improving but high unemployment persists. Inflation has been reduced but large questions remain about Federal budget deficits and interest rates.

In this complex and uncertain economy I do not have a $73 billion solution but I do have three recommendations concerning broad tax policy and specific tax legislation.

Our first recommendation.—Declare a legislative moratorium.

What is the tax law? Recently a political leader decried the Internal Revenue Code, labeling it a "national disgrace." I would not go that far but I will confess that as an active tax practitioner it is sometimes difficult to stay abreast of current developments. In the 13 years since the Tax Reform Act of 1969 was enacted, there have been 13 major tax revisions:

Revenue Act of 1971, Employee Retirement Income Security Act of 1974 (ERISA), Tax Reduction Act of 1975, Revenue Adjustment Act of 1975, Tax Reform Act of 1976, Tax Reduction and Simplification Act of 1977, Energy Tax Act of 1978, Revenue Act of 1978, Windfall Profit Act of 1980, Omnibus Budget Reconciliation of 1980, Bankruptcy Tax Act of 1980, Economic Recovery Tax Act of 1981 (ERTA), and Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

This list does not include two Technical Corrections bills, two Social Security bills, revisions to Subchapter S, Installment Sales and numerous miscellaneous tax acts.

Some commentators called the 1969 Tax Reform Act, the Lawyers and Accountants Relief Act. The same sobriquet has been applied to ERISA, the 1976 Reform Act and now to TEFRA. Perhaps we all need some relief. An example of the plethora of legislative activity is the investment tax credit which was initially adopted in 1961. The rule is very simple:

"(a) *General rule.*—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

"(b) *Regulations.*—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B."

Unfortunately, the Internal Revenue Code sections 46 through 50 which implement the rule have been amended by 20 laws since the 1969 Reform Act with 14 of those enactments changing Code subsection 46(a). The Regulations issued under this section do not reflect fully the amendments made by 14 statutes, including the Tax Reform Act of 1976, Revenue Act of 1978, Energy Tax Act, Windfall Profits Tax Act, Economic Recovery Tax Act and Tax Equity Act. The Treasury Department and the IRS have not had the time or resources to revise the regulations for the almost annual changes to the investment tax credit provisions. Absence of regulations which reflect all legislation creates additional uncertainty for the taxpayer who must make timely business decisions.

The Internal Revenue Code sections dealing with cost recovery have been revised in 1981 (ERTA), 1982 (TEFRA) and there are rumors of changes in the real estate recovery allowances this year. The minimum tax on preference items has been changed ten times since its original enactment in 1969.

Business decisions require a reasonable, economic environment. Uncertainty and instability make sound, long-range investment decisions virtually impossible. It is any wonder that capital budgeting and financing arrangements are an art form only slightly more sophisticated than weather forecasting?

For all the difficulties that the constant changes mean to the tax advisor, practitioner or established industrialist, consider the plight of the entrepreneur. The small businessman or woman building an enterprise is hardly aware of the tax law before the rules are changed. For example, the Work Incentive (WIN) Credit was enacted as Code sections 50A and 50B by the Revenue Act of 1971. A jobs tax or employment credit was enacted by the Tax Reduction and Simplification Act of 1975; the provisions are found in Internal Revenue Code sections 44B and 51 through 53 with a noncross-referenced rule related to the deduction for wages which is contained in Code section 280C. Since their enactment both credits have been amended numerous times. The complexity, confusion and changes in the employment credits almost guarantee that the credit will not be claimed.

The frustrations with a tax system in constant flux are equally confounding to each individual taxpayer attempting to complete a Form 1040 (or even 1040EZ, or 1040A). Surely, each person appreciates the reduction in tax rates and the increases in the personal exemption and zero bracket amounts. Yet, try to explain to one of your constitutents the rules on exclusion of dividends and interest. There was one rule in the law for the year 1981 and a different rule in effect for both years before and after 1981. There is also the All-Savers special rule for part of the time period and a new rule concerning the interest income exclusion will be effective in 1985.

An individual with a vacation home must contend with tax rules which were enacted originally in the Tax Reform Act of 1976 and amended four times between 1977 and 1982.

Constant change in the rules governing economic decisions frustrate taxpayers and discourage long-range, sensible planning. What the economy, the business community, tax practitioners, the IRS and taxpayers need is relief—spelled no more legislation until we can assimilate and evaluate the results of the past few enactments.

It is time to pause, to implement the moratorium and focus on general tax policy.

Our second recommendation.—Establish a Taxation Review Study Group.

We do not recommend a study group lightly nor as a device to push tax legislation into future years. We recognize that the government requires revenues and that the funds will be raised from the public—individuals, businesses and exempt organizations. Over the 200 years of this country's history these revenues have been raised through various ways and means: customs duties, user charges, excise, income and inheritance taxes. During the same period of time, politicians and taxpayers have debated the nature, scope and fairness of these revenue-raising devices.

We believe that it is time to review the direction and the purpose of the tax laws. We envision a group composed of experts in tax policy, economic development and public administration who will be charged with advising the Congress on the most appropriate revenue-raising measures for the United States to use in the years ahead.

Over time the nature of America has changed and over time the demands we have placed on government have changed. From a small, insular agrarian society, the United States has become an international, industrial giant. Today, the nation has moved toward a service dominated, technologically sophisticated economy. From a major shipbuilding and heavy equipment manufacturing economy, our businesses have evolved into research firms specializing in microelectronics, medical engineering and telecommunications.

I would not suggest that older firms and industrial sectors should be permitted to die, but we must recognize that nations change and businesses evolve. With the new realities it is well to ask, "Do the old economic rules still govern and are the existing tax law still germane?"

The progressive income tax has been a feature of revenue raising for only the last 70 years of our 200 year history. The tax law as we know it today is the Internal Revenue Code of 1954, as amended, by 363 separate pieces of legislation. The 1954 enactment is a comprehensive rewrite of the 1939 Tax Code, as amended.

Mr. Reed, the distinguished Chairman of this Committee, outlined the need for H.R. 8300 and the history of that process during floor debate on March 17, 1954.

NEED FOR THE BILL

"Before discussing the substance of the bill, I would like to say a few words as to its background and as to why it is so badly needed. Every taxpayer knows that there is something seriously wrong with our tax laws in that they are discriminatory and are unduly complicated and obscure. Every Member of this House knows that, in many respects, they have been written so as to impede our economic growth.

"One reason for these defects is that all of existing law has been developed piecemeal. Since the enactment of the income tax in 1913, there have been at least 35 major revenue acts. The Internal Revenue Code of 1939 codified prior acts but did not extend to a complete technical review of the provisions of these acts. As a result, duplication and unnecessary complexity was inevitable. For example, one provision in the new code relating to the time and place for paying the tax shown on the return replaces 34 different provisions in existing law scattered all the way from section 53 to section 3791. Furthermore, these acts were designed with particular exigencies in mind and with little regard for the overall effect on the taxpayer.

"A second reason for the inadequacy of our tax laws is the fact that their basic provisions were written when only a relatively small number of Americans were income taxpayers. . . .

"A third and most important reason for this inadequacy is that many of our tax laws were written in days when the expansion of the economy through the free enterprise system was regarded as impossible or undesirable. If it had not been for the inflationary pressures of the war and the postwar years, the depressing effect of these laws would have been felt long before this."

HISTORY OF THE BILL

"Work on the new code was initiated by a motion made by me before the Joint Committee on Internal Revenue Taxation on August 15, 1951. The first step of our project was to find out what our taxpayers had to say about the tax laws. . . . In addition to the suggestions of the general public, leading tax experts throughout the country volunteered to work on problems in technical areas, such as those relating to taxation of estates and trusts, foreign taxes, depreciation, double taxation of dividends, pension trust and profit-sharing plans, corporate distributions and reorganizations, consolidated returns, the definition of income, and others. . . . It is impossible for me to praise too highly the spirit in which all of the members of our committee approached this tremendous task. When I say all of the members, I mean just that because almost all of this bill, I am convinced, has the full support of the members of both parties. Only a very few of the provisions were opposed in committee by a majority of the minority members." (100 Congressional Record 3322 (1954))

Perhaps after nearly 30 years and more than 300 amending laws it is time for a comprehensive review of the Internal Revenue Code of 1954.

As you will note from his remarks, Chairman Reed identified three basic reasons for the substantive rewriting of the tax law: piecemeal amendments to the law, more complex and sophisticated taxpayers, and growing economic complexities. I am certain that he would find the situation unchanged today.

I have already discussed the numerous and frequent legislative changes. Let us take a brief look at the taxpayers of today, and here I am primarily focusing on the individual taxpayer and his or her Form 1040. I mentioned earlier that I do not believe that the Internal Revenue Code is a disgrace, but I will say that many citizens believe that it is. There is a cynicism about the fairness of the tax code and a distrust of the manner in which the laws are made and administered. Some people believe that tax resistance or under-reporting are legitimate forms of protest against a tax system run amok. Should you need evidence of the sentiment, review the Committee hearings on the "tax gap" and taxpayer compliance. There can be no greater danger to our self-assessment system of taxation than a feeling among individual taxpayers that they are being used.

Quoting Chairman Reed again: "This is fundamental to the very life of the Republic: Just tax laws. Our free-enterprise system must rest upon sound tax legislation. When you take too much in taxes, you weaken the Republic, you weaken the spirit of the Republic, you discourage the people of the Republic." (100 Congressional Record 3322 (1954))

The Study Group should consider changes in the current tax laws and explore alternative tax or revenue-raising measures which will prove to every citizen that the burden of government finance imposed on him is equitable and that the law is administered fairly. As Members of this Committee, you know that one person's "loophole is another person's "economic incentive." The Congressional Budget Act indicates that a tax expenditure is a deviation from the "normal tax structure," whatever that may be. Senator Russell Long recounts the ideal tax system: "Don't tax you, don't tax me, tax the fellow behind the tree."

As legislators you must find the balance between competing economic interests while sustaining a sound national tax system. We offer our assistance to you in developing and maintaining that system.

Failure to restore confidence in the revenue collection system ultimately will produce either a "competely voluntary" or a "heavy-handed, mandatory" tax system; a result one of us would want to see. We have a workable self-assessment system. We must work to preserve it.

The third point Chairman Reed made was the nation's changing economic environment, a situation the country finds itself grapling with today. In an ever-evolving world, economic relationships are rearranged and, therefore, the governing statutes should not remain immutable.

All of us recognize that there are elements of social and economic policy in every tax, in every revenue-raising proposal. The primary task of each tax measure should be to produce the funds required for the government to execute its assigned functions. Of course, the task should be undertaken with recognition of economic efficiencies and social awareness, and of course there will be disagreements among all policy makers concerning the appropriate weighting of the various elements.

Melissa Brown, writing for the Roosevelt Center for American Policy Studies, stated succinctly: "The problem, however, is that there is no consensus on the ideal tax system or how to improve what we have. Difficult trade-offs among the basic requirements for revenue raising, economic efficiency, fairness and simplicity necessarily complicate the picture. The terms themselves often lack meaning until they are evaluated in the context of specific proposals, or a package of proposals, that can be measured against the current system." (Tax Choices page 3)

We recommend that the Study Group review the performance of the current U.S. tax system within the context of the changing national economy. Compare American policies with other tax regimes, and economic structures. Review trends in revenue, finance and expenditures. Analyze alternative revenue-generating measures without limitation or preconception. The Study Group comprised of accountants, lawyers, economists and actuaries working closely with the Treasury and IRS staffs would then prepare comprehensive recommendations on a revenue structure to meet the country's needs into the 21st century.

I would like to mention that in prior years some excellent analyses and discussion vehicles have been prepared, among them:

"The Report of the President's Task Force on Business Taxation" (September 1970).

"Proposals for Tax Change" (Department of the Treasury, April 1973).

"Blueprints for Basic Tax Reform" (Department of the Treasury, January, 1977).

"An Analysis of Value Added Taxation in the Context of the Tax Restucturing Act of 1980" (Financial Executives Research Foundation).

"The Flat Rate Tax" (Price Waterhouse, 1982).

"A Proposal for Income Tax Simplification" (Glenn M. Walker, 1979).

Over the last few years, legal scholars, economic theoriticians, political leaders and businessmen and women have discussed integrating the corporate and individual income taxes. Changes have been proposed in user fees, excise and payroll taxes. Yet, I do not believe that the debate has been focused on the crucial question: the appropriate revenue measures for a national economy undergoing dramatic transformation during the end of the 20th century.

To illustrate the public policy issue, which I believe requires an original and comprehensive review of tax policy, allow me to review briefly the current tax provisions and the tax policy implications of two issues: retirement income and housing. I have not singled out these areas for criticism but merely as simplified examples.

A nation which fails to provide a mechanism for the income security of its senior citizens fails its obligation to the most-valued members of society. A working lifetime should provide an opportunity for a retirement without fear of starvation and penury.

The Congress originally decided to provide Social Security benefits to retired private-sector employees which would be financed through payroll taxes imposed equally on the employer and the employee. The IRS ruled that upon receipt, none of the benefits were taxable to the employee; the employee had paid income taxes on his contribution when made and the FICA taxes were not deductible on the income tax return. The employer's FICA taxes were deducted on the corporate return but no income was imputed to the employee, so that the employer-paid portion of Social Security was not taxed to the employee-recipient.

Earlier this year, however, the Congress determined to accelerate the FICA tax rates. At the same time, it was determined to tax, partially, Social Security benefits upon receipt. The effect of this provision is to increase income tax revenues by $2.6 billion in fiscal year 1984.

To encourage greater retirement savings, the Congress establishd the Individual Retirement Account (IRA) and beginning in 1983 permits employees covered by employer plans also to contribute to their own IRA. There is a current income tax deduction for the contribution and deferral of any tax on earnings until distribution, generally upon retirement. This provision is estimated to reduce income tax receipts by $3.2 billion in fiscal year 1984.

At some income levels and age groups, individuals pay more in FICA taxes than in income taxes. The question should be asked: "Have we coordinated properly the payroll tax increases with the income tax deductions during the working years? Have we integrated the tax treatment of benefits with the tax treatment of contributions?"

The nation's commitment to the income security of society's senior citizens has a parallel in our commitment to housing. Home ownership has been encouraged and we are proud that most of our citizens are well-sheltered in houses which they own. Government at all levels has encouraged this trend and I do not criticize the objective. The question we might pose, however, is whether the current tax provisions are reasonably consistent and efficient in accomplishing these objectives.

The tax law permits the homeowner to deduct the real estate taxes and mortgage interest on the house. If the taxpayer sells the residence and reinvests, any gain is deferred and the basis of the new home is adjusted. If the seller is over age 55, he or she can exclude up to $125,000 of the gain from taxation. There are exclusions from taxation of the interest on certain bonds used to build homes. There has been an exclusion of interest on savings certificates and a tax credit for purchasing of a new home. There are discussions about types of tax-exempt and tax deductible housing accounts. Real estate is generally exempt from the tax shelter rules.

The Joint Tax Committee has estimated that the owner-occupied tax expenditures in fiscal year 1984 will approximate $45 billion. The All-Savers certificate provision in fiscal year 1983 has an expenditure estimate of $2.4 billion.

Again, I would ask, "Do the provisions fit together into a pattern of sound tax policy?" I would ask this question of every provision in the tax code: "Are we accomplishing our objectives reasonably and rationally?"

These provisions and other examples of piecemeal legislation to address specific problems have left the Tax Code with numerous inconsistencies and some economic distortions. Too often the legislative controversies have been over the levels of the tax rates, alternative cost recovery allowances, incentive tax credits or curtailment of exclusions. We believe it is necessary to examine closely the nature of our society and its economy and then to critique the tax system which is an integral component of it.

There is a third component which I alluded to in my introduction: the fiscal year 1984 Budget Resolution. Since the Committee is directed to prepare legislation which will result in increased revenues of approximately $73 billion in the next three fiscal years, how should it be done?

Our third recommendation.—Develop a tax refinement package.

We are not seeking further legislation; in fact, we are requesting a moratorium. Nevertheless, we recognize that the budget deficits are enormous and taxes will be increased. There is no dearth of ideas or measures which could be enacted to produce the mandated revenues. The Congressional Budget Office has prepared an analysis which was presented to the Senate Finance Committee. The Treasury Department could probably suggest modifications to the law. The Democratic Study Group compiled a listing and I am certain that each Member could cite changes which he or she believes should be made.

We believe any tax changes should be incremental refinements on the current provisions or provisions which resolve open points. We believe a bridge must be built which will implement a new tax system for the years ahead. We encourage this Committee to move in phases toward a workable framework for the future.

Your Committee has produced some excellent examples of this approach in the recently enacted Installment Sales and Subchapter S revisions. A collegial effort on other items might include marital property (particularly with respect to divorce settlements), fringe benefits, insurance and leasing. While I would not single out bills to endorse, either with or without change, I know these are areas where many Members have worked intensely over the past months.

I am aware also that those measures alone do not result in a $73 billion revenue gain. The tax community and the taxpayers need a son of TEFRA like we need a son of Frankenstein. If there must be further legislation, it should represent refinements and clarifications of the existing laws. It should be accompanied by your Committee's oversight and review of the present laws while the more comprehensive policy review we have recommended is pursued.

STATEMENT OF THE PETROCHEMICAL ENERGY GROUP

On June 30, 1983, the Honorable Dan Rostenkowski, Chairman, Committee on Ways and Means, announced hearings on various proposals to increase revenue. Among proposals specifically mentioned were the Administration's contingency oil tax which would impose a $5-per-barrel excise tax on domestic and imported oil. The Petrochemical Energy Group (PEG) wishes, therefore, to submit this statement for the record in the above-mentioned hearings on the subject of the impact of energy taxes on the petrochemical industry and the U.S. economy. Since the language of the President's contingency oil tax proposal has not yet been made public and since other approaches to energy taxation have also been widely discussed, PEG's comments will be addressed to the impact of energy taxes generally, as well as the impact of a tax on imported and domestic crude oil and products as apparently envisioned by the Administration.

THE PETROCHEMICAL INDUSTRY

PEG is an ad hoc group of independent U.S. petrochemical producers. While the U.S. petrochemical industry uses only a small volume of the country's oil and gas, it has three distinguishing characteristics. First, it is energy intensive, using these energy resources both as raw materials and as fuels, commonly to a level where 25-30 cents of each sales dollar is represented by energy costs. Secondly, the industry's effect on the U.S. economy is pervasive. Some 35-45 percent of overall U.S. business activity is dependent on the U.S. petrochemical industry.[1] And, thirdly, the industry is internationally competitive and a large, positive contributor to the U.S. balance of payments.[2]

Therefore we are vitally concerned with energy taxes and we appreciate the opportunity to comment on their impact. Based on our analysis, review and experience with the quotas and fees on imported petroleum from the late 50's until 1979, we believe the following conclusions can be drawn relative to virtually all of the energy tax alternatives.

REVIVAL OF FEDERAL ENERGY CONTROLS

First, such taxes would mark a reversal of current national energy policy by turning us again toward federal price and allocation controls. Our industry has been in the forefront of those supporting initiatives to get the federal government out of energy regulation. We vigorously supported the President's early action to decontrol oil. We are also working for elimination of federal controls on natural gas. Energy taxes would mark a significant return toward federal control of energy prices and inevitably a return of federal allocation of energy.

The price and use of energy can be controlled through taxation just as surely as through the price regulations and entitlements programs the President has terminated. To give one example, a tax would impose artificial disincentives to the use of the taxed fuel or fuels. If a tax is imposed only on imported and domestic oil, clearly the government will be providing a strong incentive for industrial and residential consumers to switch to natural gas.

In addition, there is the problem of creating more administrative burdens and costs. Anyone who believes an energy tax, even one limited to imported oil, will be a simple means of raising revenue with minimum administrative complexity should look at the 1980 edition of the Code of Federal Regulations, which required 52 pages of single spaced small print, two columns per page, to set out only the directly applicable provisions of regulations required to administer the oil import fee.[3]

UNSOUND TAX POLICY

A second conclusion is that such taxes for the purpose of balancing federal expenditures would mark a new and damaging approach in federal tax policy. Unlike an income tax, this energy tax would be paid alike by industries with some profits or no profits, by those who suffer from foreign competition and those who do not, by energy intensive operations and by those relatively insensitive to energy costs.

Therefore, the impact of an energy tax will vary arbitrarily among industries and may even vary among competitors within the same industry. For example, the petrochemical industry will be doubly impacted compared with other industries because we use oil and gas not only for fuel but also for raw materials. Yet, the raw materials of other industries, steel or paper for example, will not be taxed. Thus, the impact of an energy tax on industry will be arbitrary and inequitable in some regions and industries will be affected much more than others.

DISPROPORTIONATE IMPACT ON PETROCHEMICAL INDUSTRY

For example, the petrochemical industry would pay a disproportionate share of the tax burden as a user of energy both for raw materials and fuel. A recent study by Resource Planning Consultants for PEG indicates that a $6-per-barrel import fee or refinery gate tax would cost the petrochemical industry some $2.6 billion per year in increased costs. Our raw material costs would increase $1.8 billion. Our fuel costs would increase $.8 billion. This is equivalent to almost half the funds invested in new plant and equipment in 1980 by the industry.

These new taxes would hit the petrochemical industry just as it needs all available resources to fight back from a deep recession. For example, in mid-82 the industry was operating at 65 percent of capacity.[4]

ADVERSE IMPACT ON U.S. EXPORTS

A third conclusion is that because the U.S. petrochemical industry is heavily dependent on the use of energy resources, both as fuel and feedstock, such taxes could have a seriously adverse international competitive affect on this industry and on the many other industries which consume significant quantities of our products. We have long been a strong positive contributor to the U.S. balance of trade. In 1980 this contribution amounted to over $10 billion. A tax on U.S. energy would drive the raw material costs of our industry above those of our foreign competitors. Not only will our ability to contribute to the balance of trade be limited, but imports of foreign petrochemical products which now are small, will increasingly flow into the United States to replace the capacity that U.S. producers forfeit. Also, new petrochemical investment will be forced abroad.

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[1] "The Petrochemical Industry and the U.S. Economy," A Report to the Petrochemical Energy Group by Arthur D. Little, Inc., December 1978 at 1.

[2] In 1981 the petrochemical trade balance was a positive $8 billion.

[3] 10 C.F.R. pt. 213 (1980).

[4] U.S. Department of Commerce, U.S. Industrial Outlook, 1983, January 1983, 9-6-9-7.

In order to quantify these impacts, a study conducted for PEG by Arthur D. Little, Inc., analyzed the impact of a circumstance where U.S. energy prices were 20–40 percent higher than world prices. The study showed an increasingly serious impact over time not only on the health of the domestic petrochemical industry, and its customers, but on its export trade, imports of petrochemicals, and on investment patterns.[5]

ADVERSE IMPACT ON CONSUMERS OF PETROCHEMICAL PRODUCTS

Not only is the petrochemical industry directly affected, but there is an even more devastating impact of these high energy costs on some of our customers. Some sectors are hit much harder than the petrochemical sector which would show a production decline of 11 percent in 1990. In contrast, the furniture industry is forecast to show a loss in production value of 13 percent; building materials of 17 percent; motor vehicles of 6 percent; and boats, motor homes, and recreational vehicles of 22 percent. As these projections show, the impact of an energy tax would be pervasive throughout the economy.

These are but a few of the conclusions of the Arthur D. Little, Inc., study which is Appendix A to our prepared statement. We would be happy to discuss these results in more detail with the Committee Staff should you so desire. We have also attached (Appendix B) a compilation of recent government studies of the broad economic impact of an energy tax. These studies leave no doubt of the damage an energy tax will inflict on all sectors of the U.S. economy.

CONCLUSION

In view of the strong likelihood of adverse economic impact not only on our industry but on many other manufacturing sectors, we urge the Committee to exercise great caution in turning toward energy as the preferred source of revenue for balancing federal expenditures.

If energy taxes are found to be a necessary element in a budget closure package, the high exposure and impact on individual sectors of the economy should be carefully analyzed and mitigated to the degree possible.

We appreciate the opportunity to offer these comments and look forward to supplementing this record when and as more specific details of energy tax alternatives are developed.

Sun Company, Inc.,
Radnor, Pa., July 19, 1983.

Hon. Daniel Rostenkowski,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Chairman: The Committee is beginning a review of present tax law in response to the recent Joint Budget Resolution. That Budget Resolution points to tax increases of $12 billion in fiscal year 1984, $15 billion in fiscal year 1985, and $46 billion in fiscal year 1986.

In Sun Company's opinion, great care must be exercised in addressing the subject of tax increases. Certainly, the emerging economic recovery must not be thwarted. Further, any tax legislation this year should be consistent with longer term reform which encourages economic prosperity and true capital formation, while simultaneously raising adequate revenues.

While there may be potential need for new revenues in the order of $12 and $15 billion for fiscal years 1984 and 1985 it is not clear that these can be raised without substantial harm to the recovery. However, there may be areas where unintended applications of existing law occur. The rapid increase in the number of uneconomic tax shelters, many involving tens of millions of dollars, may be an example. However, it is not evident that sufficient items of this sort can be found which will not hurt the current economic recovery.

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[5] "The Impact of Changing U.S. Feedstock and Energy Costs on the Petrochemical Industry and the Economy," a report to the Petrochemical Energy Group by Arthur D. Little, Inc., April 1981.

We urge that where there is a substantial question, you and the Members of the Committee come down on the side of avoiding harm to the recovery, even if this means a bill which does not meet fully the dollar revenue targets for fiscal years 1984 and 1985. This would not be inconsistent with reported statement of the Budget Committee Chairman on flexibility in the distribution of tax increases over the thre-year budget period.

For the out years, beginning with fiscal year 1986, we urge that no definitive action be taken at this time. A substantial structural tax increase may be needed to bring longer term, full employment revenues into line with longer term expenditure levels. This is by no means certain. It could be avoided with a national consuensus to slow rate of growth of Federal spending. Over half of the budget is composed of so-called "uncontrollable" entitlement programs. These and other non-defense discretionary programs that continue to grow in real terms can and must be brought under control. However, assuming that a tax increase will be needed, it is of great importance that it be designed to promote economic growth, not restrain it.

A high marginal propensity to consume has led to low rates of saving in the U.S. and has reduced the amount of capital available for investment. Thus, two interrelated points are key to any new tax. First, the tax should be designed so that while preserving an appropriate balance between consumption and savings, it taxes income withdrawn for personal consumption but does not tax income left in productive investment. Second, the new tax, together with appropriate changes to current law, should act as a positive force in attracting the equity capital needed to rebuild and modernize much of the country's productive capacity. There is particular need to attract equity capital to America's "hard hat" industries.

Development of this kind of tax reform will take time—time for Congress, Treasury, and interested taxpayers and tax groups to do the analytical work, time to consider and evaluate it, time to build broad concensus. Drafting large, long-term tax changes now, in the short time permitted by this year's budget process, risks cutting off the thoughful consideration and discussion which major tax reform merits. Without debating the need for a $46 billion tax increase in fiscal year 1986, it is simply premature to design it and draft it into law at this point in time.

As Sun Company develops further analyses and suggestions on how tax reform can be use to advance economic growth and the rebuilding of industrial capacity, I will be pleased to share them with you. In the meantime, if I can be of assistance, please let me know.

Sincerely,

J. P. NEAFSEY,
Senior Vice President, Finance.

TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL,
Washington, D.C., July 28, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The Travel and Tourism Government Affairs Council appreciates this opportunity to set forth, for the record, its views with respect to the Administration's proposed contingency excise tax on oil as means of meeting the revenue reconciliation instruction imposed by the fiscal year 1984 First Concurrent Budget Resolution.

The Travel and Tourism Government Affairs Council is the national organization representing the unified travel industry viewpoint on legislative and regulatory issues of common concern. The Council represents every major segment of the industry including airlines, hotels, restaurants, buses, attractions and tour sales.

The U.S. travel and tourism industry is opposed to an oil excise tax, contingency or otherwise, imposed for the purpose of raising additional revenue to offset federal budget deficits. Energy usage taxes ultimately raise fuel prices, placing a disproportionate economic burden on industries, such as travel and tourism, which are highly dependent on fuel. Though travel away from home accounted for only 9.2 percent of total U.S. petroleum consumption in 1982, transportation is dependent upon petroleum fuels for 97 percent of its total energy needs. Motor and jet fuel, at affordable prices, is critically important to the economic health of our industry.

The travel industry is now the second largest retail or service industry in the United States, having generated (in 1982) $194 billion in receipts and $20 billion in federal, state and local tax revenues. It directly employs 4.5 million Americans at every level of skill and indirectly provides another 2.2 million supporting jobs.

In short, while travel related petroleum consumption is minimal, relative to other U.S. industries, its contribution to our economy is substantial. Indeed, each barrel of petroleum consumed in 1982 generated $378 in travel spending. Every 14 gallons of petroleum consumed by travel in America directly supported one job. An additional tax or fee on fuel, direct or indirect may adversely affect employment in many service industry sectors, including travel and tourism. It is important to note that the recession forced workers to grant cost reducing wage concessions to the ailing airline and automobile industries. These landmark labor and industry negotiated agreements were designed to reduce costs. The government would, in part, dissipate these sacrificial savings by increasing energy costs.

Airlines, for example, must devote 30 percent of their operating expenditures to the purchase of fuel. A $5 per barrel oil excise tax would cost them alone in excess of $1 billion annually.

We are also concerned that since most competitors of the U.S. in the export field will not raise their fuel prices above world levels, and petroleum is a factor in the cost structure of most goods and services, the U.S. will suffer a competitive disadvantage internationally. The travel industry is currently our nation's third largest source of export revenue but our share of the international tourism market has steadily declined. With the imposition of an oil excise tax, we can expect our market share and export earnings to decrease.

Further, the tax has the potential to reverse the progress recently made in reducing inflation stimulating economic recovery. In addition, it will, to an undefinable degree, undermine the administration and funding of other important federal government programs. Such a tax, for example, may effectively preempt traditional revenue sources for the Highway Trust Fund, as well as increase petroleum acquisition costs for the Strategic Petroleum Reserve.

We therefore urge you to seriously consider the negative implications of imposing such a tax. The Council has designated this issue a 1983 legislative priority and we will vigorously oppose its adoption as we did similar proposals in 1982.

We appreciate your attention to this matter and, at your request, will be happy to provide you or your staff with any additional information.

Sincerely,

JAMES E. GAFFIGAN,
Executive Director.

STATEMENT OF NORMAN B. TURE, CHAIRMAN, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION [1]

The budget resolution's call for substantial tax increases in fiscal years 1984–1986 presumably expresses the conviction of the Congress that prospective Federal budget deficits must be reduced and that major revenue increases are necessary to do so. These budget deficits, it is alleged, will have significant harmful effects on the economy, weakening if not aborting the recovery. Last year, it will be recalled, the deficits were asserted to be insuperable barriers to the recovery which is now very sturdily under way. There is no more substance to the deficits-abort plan to the deficits-prevent recovery arguments, and one must hope that the Congress will recognize how flimsy the arguments are and turn its back on tax increases which could severely impede the course of economic progress.

The list of crimes of which budget deficits stand accused is by now familiar. Briefly summarized, these deficits allegedly: Preempt the economy's saving, thereby crowding out private capital formation; raise interest rates or keep them so high that they prevent recovery in housing and consumer durables and curtail investment in new plant and equipment; and by driving up interest rates, act as a magnet for foreign saving, which pushes up the value of the dollar relative to other currencies, thereby weakening U.S. exports and encouraging imports, slowing the recovery of employment and output.

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[1] The views presented here are my own and do not necessarily reflect the views of the Institute for Research on the Economics of Taxation (IRET).

If deficits, per se, did indeed produce these results, there would be some justification for the almost single-minded focus of Congressional fiscal policy on reducing deficits. Even so, it certainly would not follow that raising taxes is as efficient a means of reducing deficits as cutting spending, in terms of mitigating the alleged harmful economic effects of the deficits. The frequently expressed view that it is better to reduce deficits by reducing spending than by raising taxes but that if necessary tax increases are acceptable for this purpose is badly mistaken. Even worse is the aphorism that general taxes cut consumption but deficits cut investment. Views of this sort induce the Congress to adopt budget resolutions which direct the Federal Government into a very bad fiscal policy, indeed.

The by-now conventional views about deficits are mistaken on analytical grounds and have no foundation in facts. The impatience of government policy-makers with theory is understandable, but their disregard of facts is inexcusable. The facts are absolutely unrelenting in refuting the charges against deficits listed above. The facts also show that attempting to reduce deficits by raising taxes is counterproductive, will make matters worse, not better.

To begin with, deficits don't crowd out. Deficits are accounting residuals. The Federal Government spends; it collects taxes; it doesn't deficit. Spending does the crowding out by preempting some of the economy's production inputs and some of the economy's output which might otherwise be used for private sector purposes. The extent of the crowding out by a given amount of government spending, moreover, doesn't depend on how the spending is financed.

For example, if the economy produces, say, $3,600 billion of goods and services and government taxes, say, $700 billion of that output, there is $2,900 billion left for the private sector, no matter whether government runs a deficit of, say, $200 billion, zero, or no deficit at all but a surplus. And whether the government runs a deficit, balances the budget, or realizes a surplus doesn't itself determine how the $2,900 billion available to the private sector will be divided up between consumption and investment.

Suppose, for example, that the budget is balanced at the outset, that is, that taxes are $700 billion, the same as the $700 billion of government purchases, and suppose that of the $2,900 billion the private sector uses, $2,400 billion is used for consumption. Then the amount of the economy's gross private saving, by definition equal to total income (i.e., GNP) less consumption and less taxes, is in this case $500 billion, which is the amount used for private capital formation. Gross national saving, by definition equal to gross private saving plus government surplus or minus government deficit, is the same in this case as gross private saving, since the government's budget is in balance.

The first column in the following table summarizes this initial situation.

[In billions of dollars]

	(1)	(2)	(3)	(4)
Gross national product	3,600	3,600	3,600	3,600
Consumption	2,400	2,400	2,350	2,350
Investment	500	500	450	450
Government purchases	700	700	800	800
Gross national product	3,600	3,600	3,600	3,600
Consumption	2,400	2,400	2,350	2,350
Taxes	700	500	800	700
Gross private saving	500	700	450	550
Deficit	0	200	0	100
Gross national saving	500	500	450	450

Next, suppose that instead of collecting $700 billion in taxes, the government collects only $500 billion, while spending the same $700 billion, resulting in a deficit of $200 billion, as shown in the second column. Unless one assumes that GNP is greater merely because taxes are lower or investment is lower merely because taxes are—either assumption is obviously absurd—consumption must be the same as in the first case. Then gross private saving is $200 billion more than in the first case, while gross national saving is the same as in the first case. The deficit, in short, didn't crowd out private investment or private consumption; it didn't change anything in the real economy.

In a third case, suppose that the government buys $800 billion, instead of $700 billion, of goods and services and also collects $800 billion in taxes, again balancing its budget. The fact that the government buys more doesn't itself mean that the economy has more production inputs or uses them more efficiently than when the government buys less. So unless GNP is magically increased, in this case there is only $2,800 billion of output left for the private sector's use. How that $2,800 billion will be split up between consumption and saving and investment can't be inferred from the fact that the budget is in balance. If the additional government spending were for goods and services to be made available to the public as substitutes for private consumption, one might reasonably infer that most if not all of the cut in output available to the private sector would be reflected in a reduction in private consumption. On the other hand, if the additional taxes are of such a character as to raise the cost of saving and investment relative to consumption, some of the cutback in output available to the private sector will be in the form of reduced capital formation. Column 3 in the table assumes that both of these factors are at work and the cutback is evenly divided between reduced private consumption and reduced capital formation. The result is that both gross private saving and gross national saving fall to $450 billion, even though the budget is in balance. Private spending is crowded out by the increase in government spending, not by a budget deficit, which is zero in this case.

Finally, consider the case in which government spending increases to $800 billion but taxes are not increased. As in the prior case, assume that half of the increase in government spending substitutes for private consumption which declines to $2,350 billion. With taxes remaining at $700 billion, gross private saving is $550 billion; with a deficit of $100 billion, gross national saving is $450 billion; so, too, is investment. Comparing this and the prior case (columns 3 and 4 in the table) with the first two cases, it is clear that it isn't the deficit that crowds out private sector activity; it is, instead, the government spending itself.

The view that deficits crowd out and that raising taxes to reduce the deficit leaves more saving available to finance capital formation fails to account for the relationship between taxes and gross private saving. As noted, gross private saving, which finances government deficits and capital formation, is by definition the difference between GNP, on the one hand, and consumption and taxes on the other. Raise taxes and you lower gross private saving, at least dollar-for-dollar. For every dollar of reduction in the deficit, there is at least a dollar less saving. There is no more available for capital formation.

In fact, there is likely to be less. No tax increase which might be enacted will have the effect of making consumption relatively more costly than saving and capital formation; many of the tax increases are likely to raise the cost of saving and investment relative to consumption. The result, then, is likely to be a greater reduction in gross private saving than the increase in taxes, and an increase in consumption. The tax increase, not the deficit, will crowd out saving and capital formation.

The historical evidence shows that raising taxes reduces, not increases, saving and by more than the tax increases. The income tax surchage enacted in 1968 is a case in point. Consumption as a fraction of GNP rose during the surcharge years; gross private saving as a fraction of GNP fell during those years. Had the saving rates remained at the 1967 level in 1968-1970, gross private saving would have aggregated $47.6 billion more than the actual amount of saving in those years. The roughly $23 billion in additional tax revenues produced by the income tax surcharge cost more than twice that amount in lost saving. The tax increase didn't relieve crowding out; it aggravated it.

Even if one assumes that the drop in saving is no more than the increase in taxes, it is clear that raising taxes to reduce the deficit doesn't relieve crowding out. Government spending which preempts the economy's production capability and its output and taxes which inhibit private saving are the fiscal culprits.

The facts are just as intractable in refusing to support the notion that Federal budget deficits raise interest rates or keep them high. Historically, Federal budget deficits as often as not have been associated with falling, not rising, interest rates. One need not delve into the remote past to find the evidence that there is no reliable positive relationship between deficits and interest rates. Last year, interest rates dropped precipitously as the deficit soared and as the projected deficits broke through the $100 billion level and skyrocketed up to $200 billion or more. This year, as the projected deficits have come down with the more optimistic projections of economic recovery, interest rates have been rising. The facts keep insisting that there is little, if any, connection between deficits and interest rates, but this evidence, before everyone's eyes, doesn't seem to deter asserting that future deficits raise interest rates.

The historical record is just as intractable in failing to provide any solid negative association between the level of Federal deficits and the amount of fixed investment. One does find that investment tends to decline when deficits rise. But it is only the most naive sort of reasoning that attributes the ups and downs in investment to the downs and ups, let alone the levels, of the Federal deficit. The correct explanation is that rises in the deficits have been primarily the result of recessions that are associated with downturns in capital formation. In 1975, for example, the Federal deficit rose to a then record high and gross private domestic investment fell along with real GNP. The next year, the deficit remained very high—exceeded only in 1975 and in one World War II year—but investment boomed. The same thing happend in 1981: capital formation increased strongly in the face of the then third highest deficit in our history.

Nor will the facts support the argument that U.S. Federal deficits are leeching out the saving of the rest of the world. To be sure, there has been an impressive net capital inflow from abroad, for many years past. But these capital inflows show no relationship, in either amount or direction of change, with the amount or direction of change in federal deficits. Recent history lends emphasis to this fact. In 1982, as the Federal deficit increased quarter by quarter, net capital inflows decreased.

If the fear of deficits continues to dominate Congressional thinking about fiscal policy, one must hope that the focus will shift from raising taxes to reducing spending. Only by cutting back the growth in spending can the Federal Government reduce the public sector's preemption of the economy's production capacity and allow more resources to be devoted to meeting demands for additional capital as well as for additional consumption goods and services.

Raising taxes to reduce deficits will fail to reduce crowding out, as shown above, and cannot help but impede economic recovery. Virtually all taxes reduce the real rewards for providing labor or capital services. For this reason, virtually all taxes increase the costs of production. How raising taxes, thereby raising the cost of production, can possibly promote recovery defies reason and common sense. The very meaning of recovery is to increase output, hence the use of production inputs, and the income generated in production activity. Raising the cost of production inputs by raising taxes burdens recovery rather than fosters it.

If an aesthetic or ethical preference for balanced budgets is to determine the course of fiscal policy and if the budget balance cannot be achieved by spending constraint, at the very least the decision to raise taxes should be deferred until recovery is fully achieved or its full achievement is assured. At such time, a far better perspective than is provided by the present projections of the future level and path of GNP, budget outlays, and tax revenues under existing provisions will be available. How much additional taxes will be called for to achieve the desired fiscal results will be more clearly determinable than at present.

Any such tax increases, moreover, should be carefully and deliberately designed to minimize their adverse effects on incentives for work, for saving, for entrepreneurship, and for other growth-generating activities. The sort of grab-bag approach to tax increases, guided by considerations of extracting the most revenue from the politically most unpopular, hence most vulnerable, groups of taxpayers, which characterized last year's tax legislation, should be avoided at all costs. There is nothing to commend specific tax-raising measures merely because their estimated revenue gains add up to the amount of additional revenue arbitrarily specified in the budget resolution.

In this context, neither the President's contingency tax measures, called for in the budget, nor the freeze approach should be seen as acceptable. The specific tax increases proposed by the President would be poorly advised, indeed, for any purpose other than to slow the Nation's economic progress. Income tax surcharges are properly identified as special excises on saving and capital formation; excise taxes on oil must be expected to raise energy costs as a production input for virtually every business in the country. Bad as these tax increases would be for the economy, making them contingent upon the realization of specified conditions over which no taxpayer has any control maximizes the tax uncertainty which every taxpayer must face. Economic recovery requires growing confidence about future rewards for today's saving and capital formation, not the uncertainty which a contingency tax plan imposes.

The proposal to cancel or to defer the applicability of those provisions enacted in the Economic Recovery Tax Act of 1981 which are scheduled to take effect in 1984 and subsequent years is very much at odds with the requirement for a careful, deliberate approach to revenue raising, geared to minimizing adverse economic effects. If this proposal were enacted, indexing of individual income tax brackets, of the zero bracket amount, and of the personal exemption would not take effect beginning with the taxable year 1985, as now scheduled. The indexing provision included in ERTA is one of the most constructive advances in tax policy made since the inception of the income tax. It is based on a solid political principle that requires the Congress to expose itself to the judgment of the voters when it seeks additional revenues from higher tax rates, rather than being able to hide behind a facade of tax inertia while inflation escalates applicable marginal tax rates. There is nothing to be said on behalf of repealing indexing. If there were no other reason for opposing the freeze, its elimination of indexing would provide ample grounds for doing so.

The estate and gift tax provisions in ERTA were another of the major advances in tax policy afforded by that legislation. ERTA provided a schedule for increases in the unified estate and gift tax credit to take account of the effects of inflation in exposing even very small transfers to the unified tax. The imposition of the freeze would abort the scheduled increases in the credit, leaving transfers of very modest size subject to estate and gift tax. Similarly, the freeze would halt the reduction in unified estate and gift tax rates to a top rate of 50 percent. In both respects, the freeze would represent a major step backward in efforts to reduce the tax bias against saving and the adverse effects of these transfer taxes on the efficient use and disposition of property.

ERTA included a provision for progressively increasing the exclusion from tax of income earned abroad. The importance of this provision in support of U.S. business efforts to compete with businesses of other nationalities in foreign markets was extensively documented prior to the 1981 legislation. This support is as desirable today as when it was enacted. Its elimination via the freeze route would hardly represent constructive tax policy.

The several other provisions which would be prevented from taking effect by a freeze proposal also deserve far more careful consideration than the freeze proposal would afford. Such consideration conceivably might lead to the conclusion that one or more of these provisions should be modified or repealed in the interest of affording a tax law which is more conducive to efficient use of the economy's resources and less of a tax barrier to growth-generating activities. This kind of decision-making, however, would be a far cry from the elimination of those provisions merely because they had not yet become effective.

A careful, deliberate approach to tax policy formulation is difficult to attain when the tax writing committees of the House and the Senate are required to respond to revenue directives which come from the present Congressional budget process. Somehow or other, the members of the House and Senate budget committees must be made much more acutely aware than they seem to be that taxes can't be levied or paid in the abstract, that raising revenue totals mean changes in the amounts of taxes one or another group of taxpayers must bear, and that any and all such tax increases must require adjustments, often painful ones, in what taxpayers do. The revenue decisions involved in the Congressional budget procedures should not be seen as focusing solely or even primarily on broad fiscal policy considerations; they must be seen, instead, as implying changes in the tax structure which may have very grave consequences for the effective performance and growth of the economy. Such changes should not be regarded as side effects, of secondary importance, of the budget process. One way or another, these fundamental concerns of tax policy must be given far higher priority than they now enjoy in setting overall budget policy and programs.

USAIR GROUP, INC.,
Arlington, Va., September 12, 1983.

JOHN J. SALMON,
Chief Counsel, House Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: USAir Group, Inc. supports the proposed legislation embodied in S. 1557 and H.R. 3025. Enclosed is a brief statement submitted in support of S. 1557 which is scheduled for hearing on Monday, September 19, 1983 before the Subcommittee on Savings, Pensions and Investment Policy and Subcommittee on Taxation and Debt Management.

Having just completed our first offshore financing, we vigorously support early action on this legislation. We envision the attributes as being wholly positive for the United States and the domestic companies and negative only to select foreign governments and those professionals specializing in these financings.

Your encouragement of prompt and favorable adoption of the legislation is solicited.

Sincerely yours,

W. D. HAY,
Vice President Corporate Affairs.

Enclosure.

USAir Group, Inc. is a United States corporation whose business activity at present is the operation through USAir, a wholly owned United States corporation, of airline operations for the transportation of passengers, property and mail.

USAir is capital intensive having placed into service, during the three years concluding with 1982, five new Boeing 727-200 aircraft, twenty new DC-9-30 aircraft and six new Boeing 737-200 aircraft. In 1983, three new and two used Boeing 727-200 aircraft and twelve new Boeing 737-200 have been or will be placed in service. In addition, firm orders exist for five additional Boeing 737-200 and twenty Boeing 737-300 aircraft for deliveries during 1984, 1985 and 1986. Planned capital expenditures of as much as $250 million a year over a period of time necessitates accessibility to all financial markets.

In September 1983, USAir Group, Inc. borrowed $50 million through the Eurodollar market on advantageous financial terms at lower long-term rates than available domestically. This and other financings are essential for equipment modernization (productivity improvement and energy conservation), domestic business expansion and creation of new jobs, both to the airline and to the domestic aerospace firms.

The current mechanism for offshore financing is cumbersome and adds an unproductive element of costs which could be avoided under proposed legislation. The cumbersome mechanism also creates a longer time period to consummate such transactions which can be critical in the financial markets. A prior offshore financing effort was in fact aborted because of changing market conditions. Further, to avail oneself of the foreign capital, there is some tax payable to foreign nations which becomes a loss of revenue to the United States Treasury. This loss of revenue to the Treasury may not be major but is a concern to the United States corporation which feels trapped by the mechanism under which payment to foreign nations is required.

For the above generally stated reasons, and for the reasons more specifically addressed in the introductory statements by Mr. Gibbons to H.R. 3025 and by Messrs. Chafee and Bentsen for S. 1557, USAir Group, Inc. fully endorses the proposed legislation inherent in these Bills.

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